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Department of the Treasury

Bureau of Alcohol, Tobacco and Firearms

HANDBOOK

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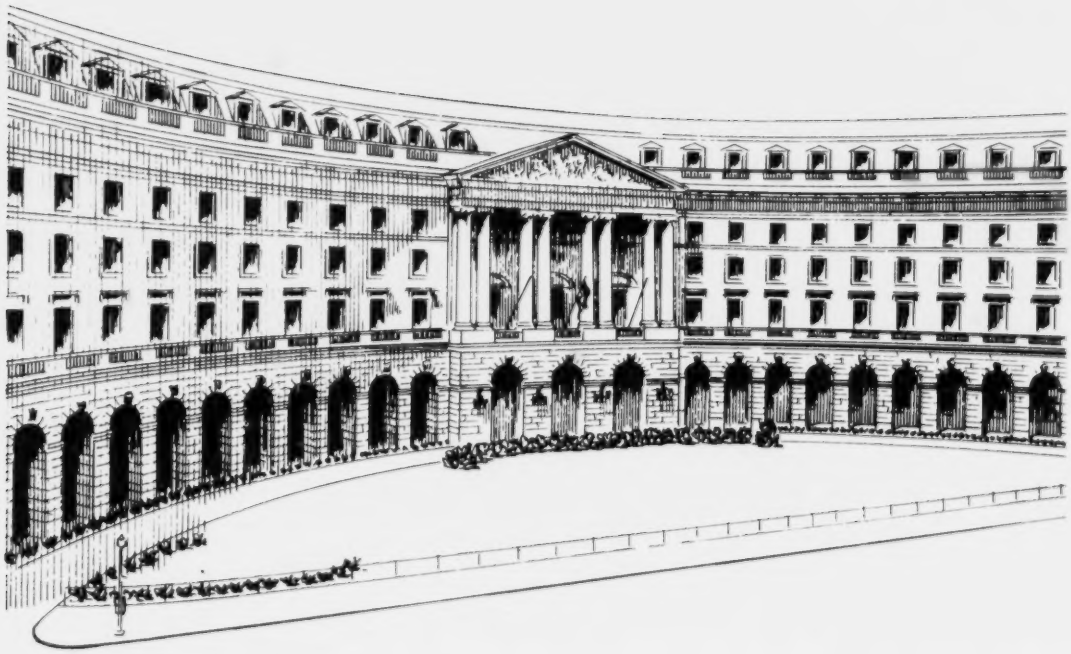
COMPLIANCE OPERATIONS

TAX COMPLIANCE HANDBOOK



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OPI: Regulations and Procedures Division

FOREWORD

1. PURPOSE. This handbook prescribes standards and provides techniques and procedures for conducting tax compliance examinations.

2. SCOPE. This handbook applies to all Compliance Operations personnel conducting tax compliance examinations of alcohol and tobacco taxpayers. The procedures and techniques contained herein also may be used whenever appropriate in other inspections, audits or investigations.

3. CANCELLATION. This handbook replaces ATF H 5030.1, Regulatory Enforcement Audit Handbook, dated June 7, 1979, which is canceled.

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Associate Director
(Compliance Operations)

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CHAPTER A. INTRODUCTION

1. APPROACH. ATF's tax compliance program is designed to assure the collection of alcohol and tobacco excise taxes. To meet this objective, ATF officers must utilize techniques and procedures which are cost effective, practical, and based on sound theory. This handbook provides a general discussion of techniques and procedures which should be utilized in conducting tax compliance examinations. Since the treatment of these subjects in a handbook format is, of necessity, somewhat broad and all encompassing, ATF officers are encouraged to use their own creativity and ingenuity to tailor these general guidelines to the requirements of particular assignments.

2. TAX COMPLIANCE OBJECTIVES. The primary objectives of a tax compliance examination are:

   a. To determine if excise taxes have been properly determined and timely paid.

   b. To determine an industry member's compliance with applicable provisions of the Internal Revenue Code and regulations.

   c. To provide ATF management reasonable assurance that the internal controls in the areas of accumulation and payment of excise taxes are adequate.

3 - 4. RESERVED

CHAPTER B. STANDARDS AND LEGAL AUTHORITIES

5. EXAMINATION STANDARDS. The American Institute of Certified Public Accountants and the U.S. General Accounting Office have developed generally accepted standards applicable to various types of audits. ATF has adopted the following standards, which are based on those promulgated by the AICPA and GAO, modified to apply to the conduct of tax compliance examinations by ATF officers.

a. General Standards.

(1) The ATF officers assigned to perform the examination must collectively possess adequate professional proficiency for the task required.

(2) In all matters relating to the assignment, ATF officers must be free from personal and external impairments to independence, and shall maintain an independent attitude and appearance.

(3) Due professional care is to be exercised in the performance of the examination and in the preparation of the report.

b. Standards of Field Work.

(1) The work is to be adequately planned and team members, if any, are to be properly directed.

(2) There is to be a proper study and evaluation of the existing internal controls as a basis for reliance thereon, and for the determination of the extent of the tests to which examination procedures are to be restricted.

(3) Sufficient competent evidential matter is to be obtained through inspection, observation and confirmation to afford a reasonable basis for conclusions and recommendations concerning the accuracy of the excise tax paid and compliance of the operations under examination.

(4) A review is to be made of compliance with applicable laws and regulations including published rulings and letterhead variances.

(5) A written record of the ATF officer's work shall be retained in the form of workpapers.

c. Standards of Reporting.

(1) Written examination reports are to be prepared giving the results of each examination.

(2) Reports are to be submitted in a timely manner.

(3) A description of the scope and objectives of the examination is to be included in each report along with a statement that the examination was made in accordance with ATF examination standards.

(4) Reports shall contain an expression of opinion on the accuracy of the excise tax returns examined, the entity's compliance with applicable laws and regulations and the adequacy of the internal controls that relate directly to the excise tax determination.

6. ACCESS TO RECORDS.

a. The primary authority allowing access to records in tax compliance examinations is 26 U.S.C. 7602. This section is a broad authorization to examine any books, papers, records, etc., to ascertain the correctness of tax returns or to determine tax liabilities and to summon individuals to appear, to produce related documents and to provide relevant testimony. Information required for a tax compliance examination is not limited to "required records." This statute is interpreted by the regulations set forth in 27 CFR 70.22.

b. Generally accepted government auditing standards for financial and compliance audits, issued by the U.S. General Accounting Office (GAO), prescribe that to prevent duplication of effort, government auditors should use to the maximum practical extent the work that other auditors or internal review personnel have previously performed. These standards reinforce our authority to have access to audit reports prepared by others.

c. Access to various records and materials, including the proprietor's internal and external audit products has been tested in the courts in a number of IRS cases. In general, the courts will agree to enforce a summons for records when:

(1) The information is sought for a valid purpose.

(2) The information sought is relevant to that purpose.

(3) The government does not already have the information.

(4) Proper administrative steps required by relevant statutes have been followed.

d. Information required for verification of a proprietor's excise tax liability is ATF's primary concern in a tax compliance examination. Records and documents directly related to that determination should be available for inspection. This includes the internal controls relative to the accumulation and payment of excise taxes. Internal and external audit products also appear to be covered to the extent they may be germane to the conduct of the examination.

e. Section 7602 also provides ATF officers with the authority to serve summons and/or a subpoena. The specific procedures relative to this activity are outlined in 27 CFR, Part 70. All officers should obtain clearance from the RD(C) or CFO prior to contacting regional counsel for guidance in initiating any such action.

f. If income or excise tax returns or related case files from IRS are needed during an examination, refer to ATF O 5190.3B, Acquisition of Tax Returns and Return Information From IRS, for the authority and specific directions.

g. Information on publicly held alcohol and tobacco companies is available from the Securities and Exchange Commission (SEC). The SEC maintains public information files on required filings of financial data and confidential investigative files. They will only have data on those companies that are required to file with the SEC. Informal arrangements have been established between SEC and ATF to obtain the confidential files. Contact the Industry Compliance Division, Bureau Headquarters, if you need further information.

7. OTHER STATUTORY AUTHORITIES

a. Entry of Premises and Penalties - Refer to ATF H 5030.2, Inspector's Handbook, for specific statutory references.

b. Detention - Authority for ATF officers to detain containers of distilled spirits, wine and beer is provided in 26 U.S.C. 5311. For additional material, refer to the Inspector's Handbook.

8. DISCLOSURE

a. Primary references - 26 U.S.C., Sections 6103, 7213 (returns and returns information), 18 U.S.C., Section 1905 (Trade Secrets Act) and 31 CFR, Section O. 735-47 (Money and Finance: Treasury).

b. Delegation of authority to disclose ATF records or information - 27 CFR, Section 71.27.

c. ATF O 1200.16, Implementation of the Freedom of Information Act and the Privacy Act.

d. Contact the Disclosure Office, Bureau Headquarters, if additional information is needed.

CHAPTER C. EXAMINATION TECHNIQUES AND PROCEDURES

9. THE PLANNING PROCESS.

a. Adequate planning is essential to ensure efficiency in satisfying the objectives of the examination. Planning involves development of an overall strategy for the expected conduct and scope of the examination.

b. Due professional care requires using good judgment in choosing tests and procedures to achieve the objectives. Proper planning maximizes the reliability of evidence selection, examination, and analysis. Due care imposes a responsibility on the independent examiner to perform the work by adhering to generally accepted standards in conducting field work and preparing related reports.

c. Active participation and coordination between the supervisor and the field officer is important to achieve the examination objectives.

(1) Balanced scheduling and assigning priorities consistent with the relative risk of each taxpayer's operations ensures against expenditure of staff time and resources on unnecessary work.

(2) Set objectives, in addition, special instructions from the supervisor, Region, or BHQ may need to be considered. Preplanning ensures that results will satisfy the objectives.

(3) Establish coordination of work to be performed and staffing.

(a) Select additional personnel, as necessary, to be used on the assignment based on needed qualifications, experience, and/or OJT exposure. A team leader must be designated.

(b) Consider requesting special assistance from support staffs (laboratory, legal, etc.).

(c) Allocate time budgets to project target or completion dates for the various phases of the examination. Provide for progress reports or timely notification to the supervisor if delays or significant findings occur.

(4) Collateral or multisite examinations will need coordination. For multisite examinations the originating office should provide instructions as

to the procedures, if any, to be completed at each location visited. Ordinarily a separate examination program should be completed for each entity for which a separate report on findings will be issued, or where local conditions may suggest separate planning considerations.

(a) Collateral examinations are different from multisite examinations. Multisite examinations are full scope tax compliance examinations conducted simultaneously at several related plants. Collateral examinations are conducted only to verify, confirm and/or secure data from a source other than the one where the primary examination is being conducted.

(b) Collateral examinations should be requested when examination steps cannot be fully completed at the examination site, e.g., when required documentation is maintained at a related facility such as a corporate headquarters. A collateral examination may also be desirable to verify bulk shipments and billings between unrelated industry members.

10. PRE-EXAMINATION PROCEDURES.

a. A review of plant data files and a survey of other permanent files should be made to obtain pertinent background information.

(1) Familiarization with operations and principal personnel from organizational and operational flow charts.

(2) Internal control evaluations and flow charts (ref., CHAPTER F - EVALUATION OF PROPRIETOR'S CONTROLS) Identify strengths and weaknesses and assess reliability of the taxpayer's operational and recordkeeping systems.

(3) Compliance history/Reports of Violations issued may indicate repetitive problems or trends.

(4) Considerations such as waivers, special permissions, limited bonds, hours of operation, etc., should be noted.

(5) Results of last examination indicate compliance and/or follow-up requests. The disposition of prior examination recommendations should be ascertained.

b. The regional TS may be contacted to obtain information material to the examination:

(1) Tax return data, as receipted by IRS, is verifiable only from regional files (ATF Procedure 82-1, eff. 9/1/82).

(2) Monthly reports of activities, documents covering in-bond transactions and exportation documents, etc. can be requested for verification of timeliness and accuracy.

c. Advance notification to the proprietor is required to prearrange access to records and responsible personnel, working space, and scheduling of an inventory (Procedures and Format, reference ATF O 5000.12, R.E. Advance Notification Procedures).

11. EXAMINATION PROGRAMS.

a. A written examination program should be prepared in advance for each tax compliance examination (see exhibit 1). The program should be as detailed as practicable, and modified as necessary in the field, particularly as the extent of testing is broadened or narrowed based on the determination of internal control strengths and weaknesses.

(1) Programs are developed under the direction of the supervisor, whose experience and appropriate adaptation of previous programs is a time saving technique. It is the supervisor who establishes the general scope of the assignment, staffing, deadlines, and continuity to past and current developments affecting the taxpayer.

(2) Preparation is based on the applicable laws and regulations governing the taxpayer's operations. Also taken into account is information established from the planning considerations, such as the prior internal control evaluation.

b. An examination program provides a systematic series of procedures, divided into logical units, which details the steps and practices to be followed in conducting the examination and preparing the report. The ATF officer may utilize an existing program, tailor that program, or prepare a new program in accordance with instructions from regional or area office management.

(1) The program is established to systematically assign, direct, and summarize the field staff's complete examination.

(2) The program format provides for the description of each work step. A predetermined indexing is established to facilitate control and arrangement of workpapers while field work is in progress. Provisions are made to accommodate cross-referencing to the workpapers and identify the staff member performing the task and the completion date.

(3) The program is not used as a checklist; it is written to communicate to the reader such information as purpose, scope, and objective of the examination, as well as providing limited background, procedure, and format information. It is not intended to deter independence or constructive thinking.

(4) The examination program most likely will require modification once the field work has begun. Tailor the program to the distinctive characteristics of each company. Flexibility is needed to expand into operations with weak controls, unreliable evidence, or poor examination test results.

c. An examination program also serves other purposes:

(1) It places responsibility and promotes an efficient division of tasks among the examination team members. This assures achievement of the objectives while coordinating and controlling work to be done.

(2) The examination program becomes a summary record of work performed. It is also a supervisory tool used to assure the adequacy of the plan and of the resources allocated, to monitor satisfactory progress of the examination, and as an aid in reviewing the tax compliance examination workpapers, schedules, and report of findings.

(3) A program may be employed as a training aid for both new personnel or for staff unfamiliar with an operation or business entity. It also serves as a guide for future planning.

12. SCOPE OF EXAMINATION.

a. The scope identifies the extent of the examination to be undertaken. The supervisor and team leader purposefully select and indicate the type of examination to be made and the extent of time, activities, and functions to be covered.

(1) Based on previous work, primarily internal control evaluations, professional judgment should be exercised to assure that adequate time and proper attention are devoted to material matters and to minimize time spent on less critical concerns.

(2) Begin with the "Open Return Concept," i.e., consider all previously unexamined tax return periods as subject to review up to the statute of limitations (26 U.S.C. 6501 - 3-years. Under certain conditions as cited in 6501, the 3-year limit can be waived). Vary from this as site conditions warrant:

(a) Narrow or stratify the matters under examination to minimize time expenditures where controls are sufficient or risk is not significant.

(b) Expand or intensify the examination where conditions indicate potential tax deficiencies, control inadequacies, or regulatory non-compliance.

(3) Scope may be affected by existing orders, special policy, or instructions issued with the particular assignment.

(4) Scope limitations exist where there is any restriction on the ATF officer from performing all practical procedures necessary to arrive at an unqualified conclusion. For example, denial of access to source information, inadequate or incomplete records, time constraints, etc., constitute scope limitations. These situations should be referred to your supervisor immediately for possible resolution. However, if such restrictions cannot be overcome by resorting to satisfactory alternatives, the limitations must be reported and considered in any finding.

13. OPENING CONFERENCE.

a. Arrange for an opening conference immediately prior to any on-site work.

(1) Reiterate the purpose and scope as expressed in the advance notification letter. Discuss preliminary inventory schedule and procedures.

(2) Request suitable working space and familiarize yourself with the taxpayer's operations. A tour

of the plant will point out key areas for source information, how the operations actually work, and whether the reported activity is bona fide.

(3) Establish a mutual understanding of on-the-job authorizations and limitations. This includes information sources, safety rules, office equipment usage, etc.

14. ON-SITE UPDATES.

a. Changes, corrections, and new information should be reflected in the plant data file as a complementary activity to the ongoing examination (Ref. ATF O 5030.6A). The examining officer should ensure that the flowcharts and organizational charts properly reflect current operations.

(1) Initial and date agreement on documents that are current.

(2) Annotate new documents that they have been amended or are updated versions.

b. The supervisor and/or team leader will perform periodic on-site checks to assure that the objectives are being achieved and field work is within the projected time budgets. Team members have the opportunity to explain problems, delays, or preliminary findings and to suggest modifications to the program or new approaches for economy and efficiency in the ongoing review.

15. CLOSING ACTIONS.

a. Prior to completion of on-site work, the ATF examination team should discuss with the area supervisor (and RAM if appropriate) the extent and results of the review. The responsible supervisor should determine whether:

(1) Tests and evidence are sufficient to support the findings and conclusion.

(2) The resolution of violations and the proposed recommendations are reasonable.

b. An exit conference should be held upon completion of on-site work with the taxpayer or his responsible representatives.

(1) Summarize work performed and preliminary results, which are subject to managerial review and possible changes.

(2) Discuss violations, unless further investigation would be jeopardized, and seek corrective action before you finish.

(3) Inform company officials that a report of findings concerning tax and regulatory compliance will be filed.

CHAPTER D. EVIDENCE

16. TYPES AND EVALUATION OF EVIDENCE.

a. General. Evidence is any material gathered during the course of an examination which documents a particular activity, operation or event. Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the ATF officer's judgments and conclusions. A written record of the ATF officer's work is to be retained in the form of workpapers.

b. Types of Evidence. Evidence may be categorized as physical, documentary, testimonial and analytical.

(1) Physical and documentary evidence is obtained by direct examination of a proprietor's records or observations of activities and operations. Such evidence should be in the form of a complete description of records examined or activities observed. Samples of records examined may be useful to provide a clear picture of the records examined.

(2) Testimonial evidence is obtained from others through inquiries or interviews. Testimonial evidence which is critical to the ATF officer's judgments and conclusions should, to the extent possible, be corroborated by checks of records and physical tests.

(3) Analytical evidence includes computations and spread sheets which should clearly indicate the purpose, source and nature of information analyzed or computations performed, and the conclusions reached.

c. Quality of Evidence. The concepts of sufficiency, competence and relevance are explained as follows:

(1) Sufficiency. Sufficiency is the presence of enough factual, adequate, and convincing evidence to lead prudent persons to the same conclusion. Determining the sufficiency of evidence requires judgment, because there frequently is conflicting evidence and the ATF officer must make an impartial judgment as to what position is supported by the weight of the evidence. When appropriate, statistical methods may be employed to establish sufficiency.

(2) Competerce. Competent evidence should be reliable and the best attainable through the use of reasonable analytical methods. In evaluating the competency of

evidence, the ATF officer should carefully consider whether there is any reason to doubt its validity or completeness. If there is reason for doubt, the ATF officer should take additional measures to authenticate the evidence. The following presumptions are useful in judging the competence of evidence. However, these presumptions are not to be considered as sufficient in themselves to reach a conclusion.

(a) Evidence obtained from an independent source provides greater assurance of reliability than that secured from the organization being examined.

(b) Evidence developed under a good system of internal control is more likely to be reliable than that obtained where such control is weak or unsatisfactory.

(c) Evidence obtained by the ATF officer through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

(d) Original documents are more reliable than copies.

(3) Relevance. Relevance refers to the relationship of the information to its use. The facts and opinions used to prove or disprove an issue must have a logical, sensible relationship to that issue. Information which does not have this relationship is irrelevant and therefore should not be included as evidence to prove or disprove a point.

CHAPTER E. WORKPAPERS

17. WORKPAPER FILES.

a. General This chapter presents general criteria for developing workpaper files in an orderly manner and includes an example of a partial workpaper file. Judgment should be exercised in the preparation of workpaper files. Accordingly, the general criteria set forth herein should be tailored as needed for specific examinations.

b. Contents. The term workpapers refers to all documents and papers prepared or collected by the ATF officer during the course of an assignment which document the work done. An individual workpaper should document only one subject. This one subject restriction promotes clarity, appropriate indexing and appropriate placement in the workpaper file. Workpapers may be either narrative or computational in format. Workpapers provide a basis for:

(1) Discussing the results of the examination with the industry member as well as with ATF reviewers.

(2) Supporting the results of the examination and recommendations.

(3) Reviewing and supervising the on-site officer's performance.

All workpapers should be uniform with regard to physical and general requirements. The content within these requirements is determined by what meets examination standards for the particular assignment, as interpreted by the ATF officer's judgment.

c. General Workpaper File Objectives. The primary purpose of the workpaper file is to document in a logical sequence the work performed during an examination and support the ATF officer's conclusions and recommendations. It is primarily designed to:

(1) Document the planning work done (ref., CHAPTER C - EXAMINATION TECHNIQUES AND PROCEDURES).

(2) Show the extent and degree of supervision exercised.

(3) Justify the level of testing as being sufficient given the existing conditions (ref., CHAPTER C and CHAPTER I - SAMPLING).

(4) Explain the nature, purpose, and scope of the examination.

(5) Provide a sound basis for the evaluation of internal controls (ref., CHAPTER F - EVALUATION OF PROPRIETOR'S CONTROLS).

(6) Support with sufficient, competent and relevant evidential matter, the recommendations and other data presented in the examination report (ref. CHAPTER H - REPORTING).

(7) Provide summaries of major areas of examination.

(8) Serve as a basis for planning future examinations.

(9) Serve as a basis for updating the plant data/permanent file.

d. General Requirements. As a minimum, the workpaper file is to contain the following basic information:

(1) An index describing the file content - the indexing system should be simple, provide for the logical grouping of interrelated workpapers, and should be easily expandable (see exhibit 2).

(2) A copy of the final (and draft, if appropriate) report, cross-referenced to appropriate workpapers.

(3) Notes on significant conferences with the proprietor. All conferences involving ATF officials and the proprietor which relate to the examination should be documented in the workpaper file. ATF F 5000.4, Memorandum Record of Conversation, can be used to document conferences and telephone conversations. Documentation for each conference should normally include the following types of information:

(a) The purpose and date of the conference.

(b) The names, titles and organizations of those in attendance.

(c) A summary of the points discussed.

(d) When applicable, a summary of any opposing views, relevant comments, and statements of agreement or disagreement of those in attendance, as well as conclusions reached.

(4) Documentation of the ATF officer's consideration of the work of others such as the proprietor's internal and external auditors. For example, internal

control evaluations may have been made which could substantially reduce time spent on the current effort. Such documentation should include:

(a) Description of the work and identification of the audit or other group doing the work.

(b) Evaluation of the work to establish the degree to which it can be relied upon in lieu of duplication by ATF officers.

(5) Reviewer's notes of both in-progress and final reviews of workpapers.

(6) A copy of the document authorizing the assignment.

(7) The examination program.

(8) Documentation of planning work.

(9) Workpapers detailing tests performed.

(10) Summaries of major segments of work, cross-referenced to appropriate workpapers. Systematic summarization of each major segment facilitates drafting of the report. (See exhibit 3.)

All tick marks should be fully explained on each workpaper on which they appear and should be used consistently throughout the file. Some examples of commonly used tick marks are:

foot

Crossfoot

Source document examined

e. Physical Characteristics. To provide for uniformity between field offices, the following physical characteristics are prescribed for workpaper files:

(1) ATF O 1324.5, Elimination of Legal Size Files, requires that ATF files be maintained in letter size (8 1/2x11 inch) folders. Accordingly, workpaper files should be prepared on letter size paper. If larger size paper is used, workpapers should be neatly folded to fit letter size files.

(2) The workpapers should be neat, clear, and legible. Information should allow sufficient space for

changes, additions, review notes, etc. Format should be consistent throughout the file. Where one workpaper is not sufficient to completely describe a test performed, additional workpapers in the series should flow in a logical manner and be adequately indexed to reflect that the tests performed are complete.

(3) The cover of each file should show clearly such identification as:

(a) The name of the proprietor.
(b) Permit number or location.
(c) Examination period.
(d) Type of examination.
(e) Names of examination team.

(4) The top of each page of a workpaper should contain:

(a) Name of proprietor.
(b) Permit number or location.
(c) Examination period.

(5) Each workpaper should contain:

(a) Initials of preparer and date prepared.
(b) Initials of reviewer and date reviewed.
(c) Workpaper index (at bottom center or in designated blocked off area).

(6) Workpapers should be prepared in pencil with indexing and cross-referencing in colored pencil. Use a color which normally copies (e.g., not blue).

(7) Each workpaper should include a brief description of the workpaper purpose such as, "to examine documentation which supports adjustments increasing and decreasing tax as scheduled on w/p J-5, p 2." In addition to purpose, information concerning source, scope of examination (detailing the examination steps performed) and conclusions reached should be included as follows:

(a) A brief description of records examined (e.g., overhead charge invoices, or executed ATF F 5200.14).

(b) A detailed description of examination tests performed, such as: "adjustments increasing and decreasing tax were verified to overhead charge records for July 9-13, 1984. Decreasing

adjustments represent exported cigarettes previously tax paid when executed ATF F 5200.14 not received from Customs within 90 days. Adjustments were verified to executed 5200.14 subsequently received."

(c) A description of the results of tests performed such as: "our review of the proprietor's documentation of tax adjustments disclosed that all adjustments were properly supported."

(8) The purpose of each lead or summary schedule should be clearly indicated and the examination steps performed and conclusions reached should either be documented on the schedules themselves or cross-referenced to other workpapers where such is documented.

18. REVIEW OF WORKPAPERS.

a. The examination standards contemplate a thorough review of the evidence of work performed. The reviewer's satisfaction with the work performed and agreement with the conclusion reached should be signified by initialing each worksheet reviewed. Questions arising from these reviews and answers thereto should be included with each group or file of workpapers.

b. The review process is important and is based on a need to be assured that there is clear, demonstrable, and objective evidence in support of examination work and related findings. In the review of the workpapers, due regard must be given to such factors as:

(1) Compliance with the examination program and any specific instructions given.

(2) Accuracy, reliability, and adequacy of the work performed and the acceptability of the related workpapers as evidence of such work.

(3) Validity and reasonableness of conclusions reached.

(4) Conformity with applicable standards and requirements of workpaper presentation as set forth in this handbook and other guidelines both regional and area.

c. Workpapers should be reviewed by the site team leader and supervisor promptly after performance of the work. Prompt review permits efficient continuation of the work to clear up questions and avoids the disruption caused by reviewing

work on an area after the team members involved have been reassigned to other work. Supervisors are expected to exercise judgment in what to review and how much to review. Those papers which are reviewed should be initialed.

19. WORKPAPER SECURITY. All workpapers and workpaper files shall be safeguarded to the extent necessary to prevent damage, and preclude unauthorized access, alterations or theft.

a. In the Field.

(1) Workpapers should not be left unattended during the day in places where they might be accessible to the public or other persons not authorized to examine them. If workpapers must be left, place them in a locked briefcase.

(2) Workpapers should be locked up overnight.

b. In the Office. Workpapers and workpaper files should be secured according to ATF O 1720.1B (PHYSICAL SECURITY PROGRAM). The minimum retention period is 6 years (ATF O 1324.2, Records Management Program and Records Control Schedules).

CHAPTER F. EVALUATION OF PROPRIETOR'S CONTROLS.

20. INTERNAL CONTROL IN GENERAL.

a. Reasons for Evaluating. A proper study and evaluation of existing controls is the basis for determining the extent of substantive testing to be done. If a particular control is to be relied upon, compliance with that control must be tested. During a particular examination, the ATF officer should realize that the degree of risk is a function of the adequacy of the internal control system and the susceptibility of the taxes to be manipulated or misstated.

b. Definition. The standard textbook definition describes internal control as comprising the plan of organization and all of the coordinate means and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition is broader than the meaning sometimes attributed to the term. It recognizes that a system of internal control extends beyond those matters which relate directly to the recordkeeping of the accounting and financial departments. However, our main concern is with the internal controls as they relate to excise taxes.

c. Accounting Controls vs. Administrative Controls. Controls to safeguard assets and check the accuracy and reliability of accounting data are called accounting controls, while controls relating to operational efficiency and adherence to managerial policies are referred to as administrative controls. External examiners are generally more concerned with accounting controls while internal auditors would also evaluate administrative controls. The ATF officer is a type of external examiner and would therefore be concerned with the accounting controls that relate to accountability and control over taxable products. These most likely would be in the areas of production, inventory control, and removals.

d. Characteristics of Good Internal Control. A satisfactory system of internal controls is one that exhibits the following characteristics:

(1) A plan of organization which provides appropriate segregation of functional responsibilities.

(2) A system of authorization and record procedures adequate to provide reasonable accounting control over receipts, production, storage, processing and disposition of taxable commodities.

(3) Sound practices to be followed in performance of duties and functions of each of the organizational departments.

(4) Assurance that the personnel are competent to meet responsibilities.

(5) System of internal review.

e. Discussion of Characteristics.

(1) Segregation of functions is sometimes referred to as division of duties. The idea underlying this separation of duties is that no one person should have control of two or three functional responsibilities. There are three general duties that should be performed by different departments or at least different employees:

(a) Authority to execute a transaction.

(b) Recording of the transaction.

(c) Custody of the assets involved in the transaction.

(2) The second characteristic means that sound procedures and methods are prescribed for use by the proprietor's employees. Examples would be a chart of accounts, procedures manuals, flow-charts of transactions and forms processing, etc. Such a system provides feedback to interested and responsible parties, both internal and external, that effective accounting control is being exercised to ensure timely and reliable information on the control and results of operations and to measure performance.

(3) A satisfactory system of practices is evidenced primarily by formal policies and procedures and, secondarily, by consistent practices or informal procedures. This system provides standards of performance designed to direct, restrain, govern and check upon the various activities. A standard describes what is to be done and how, when, where and by whom it is to be accomplished, with regard to

each significant transaction. Practices would include the many and varied error-checking routines that may be performed in connection with recordkeeping, including periodic comparisons of recorded amounts with actual quantities.

(4) A satisfactory system of staffing provides for the employment of all personnel according to their education and experience in light of duties and responsibilities to be assigned. Adherence to prescribed hiring standards ensures acceptability in this regard. The competence factor is perhaps the most difficult to evaluate. The best method of assessing competence is to observe and examine the output generated by the people, which is direct evidence of their work and indirect evidence of their abilities.

(5) Finally, a satisfactory system of internal control provides for independent review, or monitoring functions, to determine whether actual performance conforms to standards of performance. Monitoring functions may be manual (human) or automatic (EDP). Any system may be beautifully designed with complex organization charts, voluminous manuals, and detailed operating procedures; but if the people do not operate the system as it is designed, then the elaborate system exists only on paper.

21. INTERNAL CONTROL IN SMALL BUSINESSES

a. Constraints. The full array of the above mentioned characteristics will generally be present only in larger businesses, which usually have detailed and elaborate accounting and operating manuals, many specialized employees, and probably an internal audit staff or function. In small businesses, internal control, as such, is seldom given much thought or consideration. These businesses have neither the qualified staff available to set up the procedures, nor the same incentive for maintaining them, since there is no critical board of directors or stockholders checking management.

b. Evaluation Criteria. In the case of many smaller permittees and plants, where only one or two individuals function in many capacities, it is simply impossible to provide all of the required checks. The system of controls will make use of as many checks as possible under the circumstances, and ATF officers will have to

adjust their procedures accordingly. For example the key person in most of these businesses is the owner-manager. A diligent owner-manager may be able to oversee and supervise all the important authorization, recordkeeping, and custodial functions, and to assure data processing accuracy to his own and ATF's satisfaction. Thus, the ATF officer might study the extent of the owner-manager's involvement in the operations and evaluate his competence and integrity, as described earlier for characteristic number four.

22. DOCUMENTATION AND REVIEW OF INTERNAL CONTROLS. The ATF officer reviews the system to obtain sufficent knowledge and understanding about the records system and internal controls for two purposes. The first is to determine whether there are internal control procedures that may provide a basis for reliance in determining the nature and extent of substantive testing. The second is to provide assistance in designing substantive tests in the absence of such reliance.

a. Internal Control Questionnaires. The proper study and evaluation of internal control is essentially an evidence-gathering and decision-making process. One of the most efficient means of gathering initial evidence and knowledge about a proprietor's internal control is to conduct a formal interview with a knowledgable manager or employee, using an internal control questionnaire. The questionnaire should be designed so that a "No" response would indicate a weakness. After completing the questionnaire, the reviewer can readily see what areas need more discussion or analysis. An example of an internal control questionnaire appears in exhibit 4. These questionnaires should be designed to help the ATF officer gather evidence, but one must remember that answers to these questions are not competent and sufficient by themselves for final conclusions. Questionnaire evidence is like hearsay evidence. The person interviewed often describes the system the way he or she believes it should be, rather than the way it really is; thus it is necessary to conduct sufficient testing of the system during your examination to verify the accuracy of the questionnaire information. Nevertheless, the questionnaire is useful in that it provides a detailed checklist of necessary internal control items to be covered.

b. Narrative Descriptions. Another method of documenting internal controls is to write a narrative description of the internal control system or sub-system. The greatest drawback to the narrative description is that, if the system is at all complex, its revision becomes physically

more cumbersome as the years pass because any major change requires that the entire narrative be rewritten.

c. Flowcharts. A third method for documenting internal controls is to construct a diagram of the system. The advantages of flowchart diagrams can be summarized by an old cliche, "A picture is worth a thousand words." Flowcharts can enhance your evaluation, and annual updating of the chart is relatively easy with additions or deletions to symbols or lines. The disadvantages of flowcharting are said to be its greater time requirement and greater expertise in a rather unique art form. Construction of the flowchart takes more time because it cannot be completed until the ATF officer has consulted firsthand all the operating personnel involved in the system, seen all the machines or equipment, and gathered exhibits of, or examined all of, the documents. Thus, the information for the flowchart, like the narrative description, involves a lot of leg work and observation. When it is complete, however, the result is an easily evaluated, informative description of the system. Standard flowchart symbols are shown in exhibit 5. Exhibit 6 covers flowchart format and contains an example of a flowchart diagram.

d. Other. The ATF officer should also take advantage of the work of others. Company manuals may contain flowcharts or narrative descriptions of record systems that would be useful in documenting the internal control system. In addition, evaluation of controls performed by other auditors, e.g., CPA's, and company internal auditors may be useful in assessing the reliability of the proprietor's internal controls.

23. INTERNAL CONTROL EVALUATION PROCESS.

a. Preliminary Evaluation. Once the internal control system is documented, the ATF officer can assess indicated strengths and weaknesses. If the internal control system is such that it is apparent that no reliance may be placed upon it, document this conclusion and proceed to design substantive tests that do not rely on internal controls. The following steps may serve as a helpful approach in the evaluation process. They also should be considered in the design of internal control questionnaires.

(1) Consider the errors or irregularities that could occur in a record system.

(2) Consider which types of control procedures should prevent or detect these errors or irregularities.

(3) Determine whether the necessary control procedures are part of the system. These are the indicated strengths, or key controls, to be relied upon if established to be working as described.

b. Tests of Compliance.

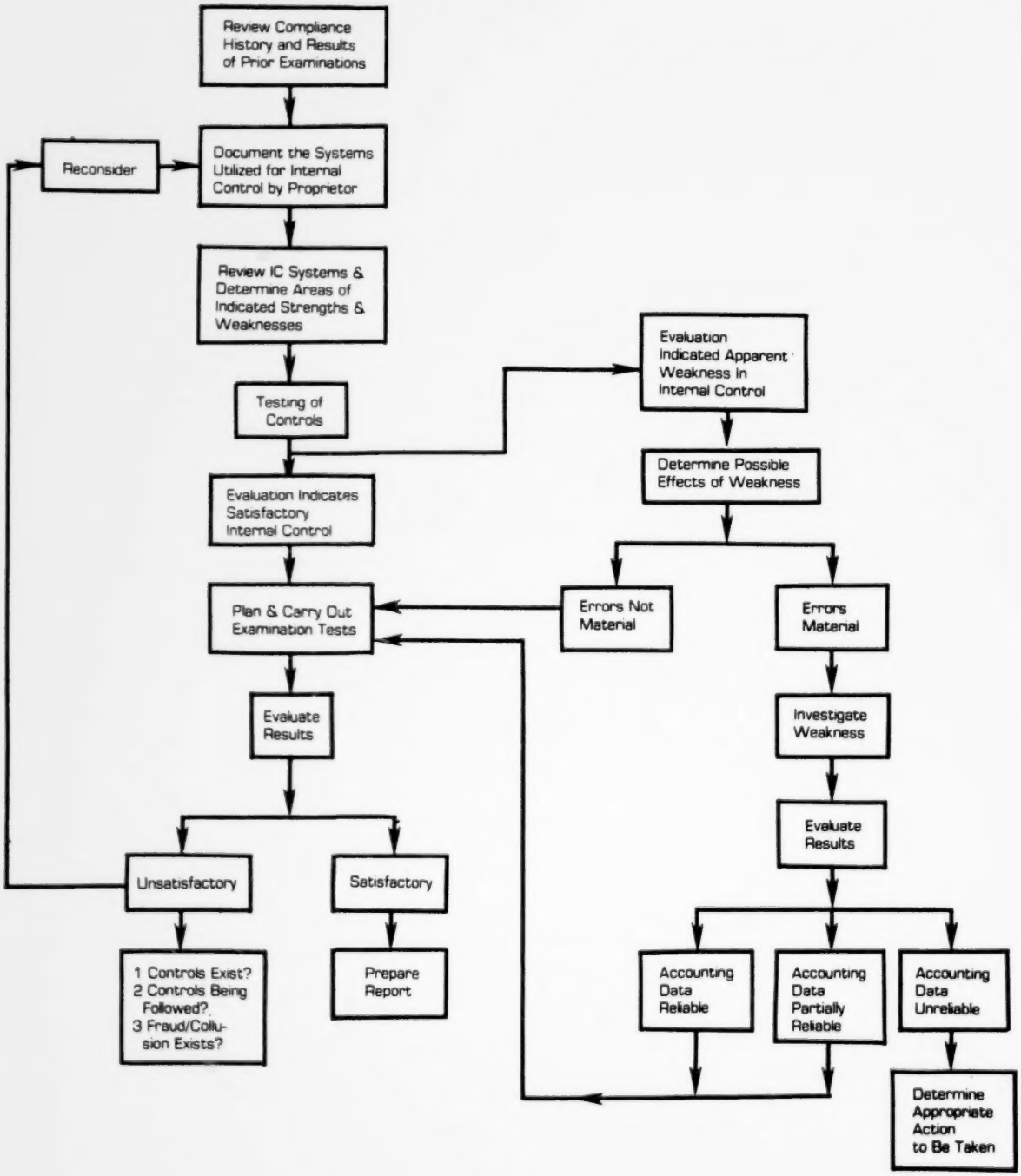
(1) The ATF officer's review and preliminary evaluation of internal controls in a particular area may indicate the presence of controls that can affect the nature and extent of substantive testing. Before reliance can be placed on the indicated strengths, these areas should be tested to determine if they are working as described. These are called tests of compliance and are generally concerned with these questions: whether or not the indicated internal control procedures are being performed; how they are being performed; and by whom.

(2) Compliance tests take various forms depending upon the internal control procedure being tested. Some procedures leave visible evidence that may be examined such as approval initials or stamps, adding machine tapes for a reperformance function, or a worksheet for account reconciliation or comparison. Others, such as a separation of duties or some internal review functions, may not leave evidence on paper and must be tested by observation or indirect means.

c. Final Evaluation. Following the completion of compliance tests, the ATF officer then makes a reassessment of the indicated strengths and whether they can be relied upon. If key controls are in place and operating, the substantive tests of record and report entries may be designed to take advantage of the relative assurance afforded by the control system in preventing or detecting errors. If controls are lacking in the system, or found not to be operating by tests of compliance, the ATF officer will need to adjust the nature and extent of substantive testing. In general, this would mean more testing and testing more aspects of an operation in the absence of reliable internal controls.

d. Internal Control and the ATF Examination. The following diagram is an illustration of how the documentation, testing and evaluation of a proprietor's controls relate to ATF's entire examination procedure.

RELATIONSHIP OF EVALUATION OF INTERNAL CONTROL TO THE ATF EXAMINATION


Review Compliance History and Results of Prior Examinations
Reconsider
Document the Systems Utilized for Internal Control by Proprietor
Review IC Systems & Determine Areas of Indicated Strengths & Weaknesses
Testing of Controls
Evaluation Indicated Apparent Weakness in Internal Control
Determine Possible Effects of Weakness
Evaluation Indicates Satisfactory Internal Control
Plan & Carry Out Examination Tests
Errors Not Material
Errors Material
Evaluate Results
Investigate Weakness
Evaluate Results
Unsatisfactory
Satisfactory
1 Controls Exist?
2 Controls Being Followed?
3 Fraud/Collusion Exists?
Prepare Report
Accounting Data Reliable
Accounting Data Partially Reliable
Accounting Data Unreliable
Determine Appropriate Action to Be Taken

CHAPTER G. INVENTORY VERIFICATION

24. INVENTORY OBJECTIVES. The objective of taking a physical inventory is to assure that the materials or products in question actually exist and to test the accuracy of the accounting records. Inventory verification is mandatory in most of ATF's examinations and may be used as an appropriate procedure in many other assignments. The type of inventory verification will range from complete counts made by ATF, to observation of proprietor counts, to test counts of items selected randomly, by inventory workbacks, or by judgment. In all types, the ATF officer must be in control of the operation - that is, he or she must be assured that the inventory exists, that it is accurately counted and extended, and properly entered into the proprietor's records.

25. METHODS OF INVENTORY VERIFICATION. The method of inventory verification used will vary depending on the particular proprietor involved, the history of compliance in the past, the results of your internal control evaluation, and the instructions given to you in specific cases by ATF orders or your supervisor. In some cases where there is evidence of willful wrongdoing, you may take a complete count of the proprietor's inventory. In instances where inventory controls are very weak or non-existent, you might want to observe a complete inventory by the proprietor. In cases where the proprietor's inventory controls are very strong, a test count of items selected from the proprietor's completed inventory might be considered sufficient verification.

26. INVENTORY GUIDELINES.

a. Planning the Inventory. If reliable results are to be achieved, it is in the inventory team's best interest to take care in advance to see that planning is adequately done. If the counting is poorly controlled and the item descriptions are indistinct and inconclusive, the ATF officer may not be able to rely on the results. Some of the things to consider in planning the inventory are:

(1) Take a tour of the premises prior to the inventory date and familiarize yourself with the location and types of products to be counted.

(2) Review and evaluate the proprietor's inventory-taking instructions to determine if controls are adequate and that any necessary ATF requirements are met.

(3) If shipping, receiving, or production operations are to be conducted during the inventory, ascertain that proper controls are planned on these stock movements.

b. Procedures During the Inventory. Some points to consider during the inventory include:

(1) Observe the taking of the inventory for compliance with instructions and to establish the existence of the products counted.

(2) Verify that the proprietor monitors all movements of stock during the inventory in order to ensure an accurate count.

(3) Verify with shipping and receiving departments which goods were last received or removed prior to the inventory count in order to ascertain a proper cut-off point.

(4) If necessary, have company personnel open some sealed cartons or containers to determine quantity and type of contents.

(5) If bulk spirits are involved, you might obtain some samples of the product to verify the proof on a spot check basis or to submit to the ATF lab for independent testing.

(6) Verify that all of the warehouse or storage areas are counted.

c. Procedures After the Inventory. Soon after the inventory you should:

(1) Make test counts of inventory items to completed inventory records then trace back some inventory record entries to the inventory items.

(2) Confirm any inventories not stored on the proprietor's premises and make such supplemental investigations as may be necessary.

(3) Compare quantities on the physical inventory with the perpetual inventory records and review the proprietor's explanations for any major differences between the two.

(4) Investigate any entries of an unusual nature made to book inventories during the period of examination.

(5) Assure that the proprietor makes appropriate adjustments to book inventory.

(6) Test valuation and extension of inventory and trace to general ledger to verify accurate recordation in the books of account.

27. EXAMPLES OF PHYSICAL INVENTORY METHODS. A good method must be used to ensure that all items are counted accurately and no items are omitted or included more than once.

a. One of the best methods is the use of two or three part count tags. The system operates as follows:

(1) Tags should be serially numbered.

(2) One person should be in control of the tags.

(3) A record of the series of tags given to each count team should be maintained.

(4) The count team records the count and makes out all parts of the tags.

(5) One part of the tag is removed and turned in with the count sheet.

(6) The other part (or parts) of the tag is (are) attached to the lot counted.

(7) At the completion of the count, each item should be tagged.

(8) The inventory should then be summarized in tag number sequence.

(9) The inventory should be summarized with like items grouped and totaled.

(10) The totals of steps 8 and 9 should agree.

(11) All tags should be accounted for whether used or not.

b. Another method used by some proprietors involves the use of count sheets with every particular inventory storage area numbered and represented on the count sheets. The warehouse is broken off into different areas (aisles, bays, etc.) identified with a number and separated from other areas by painted or taped lines or dividers. A team member would count the stock in each item and enter the figure on the count sheet in the appropriate place, and also write the count for each area in chalk or pencil on the floor. A second team member would independently check the counts.

c. Another method utilizes two independent counters who have diagrams of the warehouse showing each area to be inventoried. As the area is inventoried, its count is written on the diagram, which then shows the count in each area as it is counted, thus eliminating the possibility of leaving an area out. At the conclusion of the counts, both counters compare figures and correct any errors the other may have disclosed.

d. Regardless of the method used, the ATF officer must make sufficient tests to reach a conclusion as to the accuracy of the count and the existence of the items included.

CHAPTER H. REPORTING

28. FUNCTION AND CHARACTERISTICS OF THE REPORT

a. General. The end product of a tax compliance examination is the report of the ATF officer's findings and conclusions. The report is a permanent record of the officer's accomplishments and the formal means of communicating findings to reviewers. Reports are subject to the standards of reporting discussed in CHAPTER B - STANDARDS AND LEGAL AUTHORITIES. All reports are internal documents and are normally used only within ATF. The workpapers should be retained in the area office plant data file. The detailed workpapers are of little value in the region. The permanent files should reside in the regional office.

b. Conciseness. The report should be written as concisely as possible. The reviewer is normally familiar with the examination procedure, tax law and regulations, and industry operations. Therefore, under normal circumstances, detailed and elaborate descriptions of these areas are not necessary. The report should concentrate on essential information which is necessary to communicate significant findings.

c. Timeliness. The assignment is not completed until the report has been written and referenced to the workpapers. The report should be prepared while the examination is still fresh in the officer's mind. It should provide current information for timely action. Violations and other significant findings should be reported as promptly as possible.

d. Accuracy and Adequacy of Support. The report should be completely factual. Every statement, date, figure, and reference should be based on the best available evidence. THE REPORT ALSO CONTAINS THE OFFICER'S JUDGMENTS AND CONCLUSIONS. Whenever the officer includes his or her assessment of the facts, rather than a fact, the wording of the narrative should be such as to indicate this clearly. Expressions such as "in my opinion," "seems" and "I believe" are useful as indications to the reviewer that the writer of the report is going beyond verified facts. Conclusions should be supported by sufficient and competent evidence. The reviewer should be able to reach a conclusion from the facts presented in the report and workpapers, not from the officer's impression of the facts. For example, the officer might believe that bottling losses are excessive. However, he/she should not say this in the report unless the statement is

supported by evidence in the workpapers. This might be done by comparing losses for the current year with other years pointing out changes or trends.

e. Objectivity. The officer should present findings objectively and should include sufficient information in the report to give the reviewer a proper perspective. The officer should not exaggerate or overemphasize any adverse findings. The proprietor's views and explanations of the violations or questionable activities should always be included in the report.

f. Definitions.

(1) Case File. Includes a) report cover, b) narrative report and exhibits, c) workpapers, and d) other attachments.

(2) Report Cover. For example, ATF Form 5700.14 (Assignment and Report of Inspection) and ATF Form 5030.9 (Regulatory Enforcement Inspection Report).

(3) Narrative Report. Contains a description of the objectives and scope of examination, results, actions taken, and recommendation. It will be attached to the report cover.

(4) Exhibits. Those documents or schedules selected by the officer for inclusion in the report as evidence to support the officer's findings and conclusions. These may include affidavits, contracts, copies of invoices, production records, etc., as well as copies of key workpapers or such other summary analyses required to back up findings. The information must be significant and vital to the interpretation of the report.

(5) Workpapers. Those papers prepared or collected by the ATF officer during the course of an assignment which document the work done. The examination program is included and cross-referenced with other workpapers. Examples are inventory reconciliation, summary of operations, flow chart, verification of tax adjustments, loss analysis, audit of taxable removals, etc.

(6) Other Attachments. Included in this category are certain forms the officer must prepare, such as ATF Form 5030.5 (Report of Violation) and ATF Form 5030.4 (Removal and Submission of Samples for

Testing) and certain documents the officer obtains during the examination to correct violations or for other purposes, such as amended reports, claims, special applications, notices, etc. Attachments are normally separated from the report by the reviewer for processing and filing as appropriate. Copies should be retained in the workpapers.

29. CONTENTS OF NARRATIVE REPORT.

a. In general, a narrative report, including reports by exception, should include the following information:

(1) Date of report; permittee's name, address and registry or permit number.
(2) Conclusions (including a statement of opinion on the accuracy of excise tax returns examined, compliance with applicable laws and regulations and the adequacy of the internal controls that relate directly to the excise tax determination).
(3) Recommendation.
(4) Summary of violations and other findings, including proprietor's position regarding any unresolved or pending issues (if necessary).
(5) Objectives of examination.
(6) Scope of examination.
(7) Background information (if necessary).
(8) Results.
(9) Actions taken by the proprietor and by the officer.
(10) Signature of officer(s).

b. Discussion.

(1) Report by Exception. A narrative report will normally be written by exception. A report by exception describes in detail in the narrative only that which is improper, irregular, incorrect, unusual, or questionable, in order to establish the nature and extent of noncompliance with the law and regulations. Other aspects of the examination are documented by the workpapers (including examination program), exhibits, and other attachments.

(2) Conclusions and Recommendation. The narrative report must show the officer's conclusions as to the accuracy of the excise tax returns examined, the proprietor's compliance with applicable laws and regulations, and other matters which are material to the assignment. The report should not be submitted with a vague recommendation such as "Recommend that the matter be referred to the Regional Office for

action" or "Recommend that ATF management take appropriate action." Either no action or specific remedial action, i.e., tax, permit or other administrative action, should be recommended.

(3) Summary. If the narrative report is lengthy, it will generally be summarized to give the reviewer the gist of violations and other significant findings. A table of contents may also be used for a long narrative report to make the contents more accessible. In general, a summary will not be necessary for a narrative report of two pages or less.

(4) Objectives of Examination. In general, the objectives of a tax compliance examination are to ensure that all taxes have been properly determined and paid, to determine the proprietor's compliance with the law and regulations, and to evaluate the adequacy of the related internal controls. All narrative reports should show the objectives briefly. Since the general objectives are obvious to the officer and the reviewer, it will not be necessary to describe the objectives in detail. However, if the officer is to look into a particular area, the specific objective should be shown. The following illustrates a paragraph describing objectives:

"The examination was made to determine the proprietor's compliance with law and regulations and to ensure the proper determination and payment of all excise taxes. I was concerned especially with the delinquent monthly reports and frequent tax adjustments for the period June 1 to December 31, 1983."

(5) Scope of Examination. The scope of examination should always be stated and should include:

(a) the period (including tax return dates and total payments, if applicable) covered by the examination, and
(b) the fact that prescribed ATF standards and procedures were followed.

The period of examination should be stated very specifically such as "January 1, 1982 to June 30, 1983," not "January 1982 to June 1983." Any significant extension or curtailment of the general scope of examination must be explained in the narrative report. The following illustrates a paragraph describing the scope of examination:

"The examination covered the period from January 1, 1982 to June 30, 1983. The examination was made in accordance with prescribed ATF standards and procedures. The scope of the examination was modified as follows: 1) the scope of examination was extended to include a physical inventory of taxpaid spirits stored in a warehouse approximately 10 miles away from the distilled spirits plant, since the proprietor's transfer records from the plant to the warehouse were found to be incomplete; 2) the scope of examination was curtailed to eliminate review of qualification documents and inspection of premises, buildings, and equipment, since an application inspection was conducted five months ago to cover these areas."

(6) Background Information. Often, extensive background information will not be necessary. One consideration is the extent of any adverse findings. If significant tax adjustments or violations were disclosed, more extensive background on compliance history and any other possibly aggravating or extenuating circumstances may be necessary. Also, if a permittee's organizational structure, operations, accounting system, compliance history, etc. are unique and unusual, or have recently changed, background information may be beneficial to the reviewer in placing findings in perspective.

(7) Results.

(a) Any tax adjustments or violations should be described in detail in the narrative. Findings should be cross-referenced to the workpapers. In effect, the report is written as summary workpapers are prepared covering sections of the examination program. Tax-related findings should be treated first. A comparison between taxes paid by the proprietor and the tax computed during the examination (plus applicable penalties and interest) should be made. The officer's opinion regarding the probable cause of the deficiency and any corrective measures necessary should also be included. The proprietor's position regarding the problems disclosed and corrective actions taken or proposed should also be noted.

(b) When violations are reported, the following information should be included: 1) Specific citation of law and regulations, including

subparagraphs; 2) Extent of violations showing type, number, time period, frequency, etc.; 3) Proprietor's explanation; 4) Corrective action taken or to be taken. The description of corrective action should be very specific. ATF Form 5030.5 will be included as an exhibit.

(c) In general, treatment of any finding should include the following elements: 1) Condition, 2) Cause(s), 3) Criteria, 4) Effect(s), and 5) Recommendation.

(d) Brief descriptions of examination results in key operational areas (e.g., production, inventory), where there were no violations or other significant findings disclosed, may also be included. The extent of such material is, unless otherwise prescribed, left to the judgment and discretion of individual officers, examination teams, and immediate supervisors.

CHAPTER I. SAMPLING

30. SAMPLING AND ATF EXAMINATIONS.

a. This section addresses sampling from a practical viewpoint. A detailed discussion of the basic concepts is beyond the scope of this handbook. Each officer should select reference material and/or a text to be used whenever more detailed information is required. Any references in this section will be to Sampling in Auditing, Hill, Roth, Arkin (Copyright 1962 by the Ronald Press Co.).

b. ATF officers are encouraged to use sampling methods whenever appropriate. However, it is important to remember that sampling methods are not always appropriate. The officers must use their professional judgment to determine whether sampling is a suitable tool to be utilized during a particular examination. Judgment will also be required in development of the sampling plan and interpretation of the sampling results.

31. WHEN TO USE SAMPLING.

a. Sampling is a valuable tool to be used whenever testing of less than 100% is desired. For example, it is usually not feasible to do 100% testing during the examinations of the larger industry members. There are four objectives an ATF officer might have when utilizing sampling techniques in the field:

(1) To evaluate the effectiveness of the system of internal control in order to determine the scope of the examination and the extent of testing.

(2) To test for compliance with applicable rules and regulations.

(3) To check the accuracy of the proprietor's inventory and related records.

(4) To estimate the proprietor's excise tax liability.

b. There are specific areas of consideration that the officer should evaluate before sampling is used.

(1) Cost-effectiveness. This is the primary factor. Some applications of sampling can be extremely time-consuming, especially when the population is not readily adaptable to such procedures.

(2) Adaptability of Population. A population which is not sequentially pre-numbered should be sampled by statistical methods only if recapped in the permittee's records in some readily usable form, or if economically adaptable to an artificial numbering system. Systematic sampling (random interval selection) is an alternative method that can be used if the items are not numbered or cannot be numbered. However, this method has definite limitations which will be covered in more detail in a subsequent section. (See paragraph 34.)

(3) Materiality of Population. The population to be sampled should be material to the excise tax returns and related records or to the objective of the examination. For example, the officer may decide to sample only the high value items. Judgment plays an important role in determining the materiality of a particular population.

(4) Sensitivity of Population. Because of the importance of certain populations (e.g., removals or sales transactions which generate excise taxes), closer scrutiny and more accurate analysis are required. These types of populations are well suited for statistical examination methods.

(5) The Nature of Testing. The examination of evidential matter is accomplished through tests. For example, testing is used to determine whether reliance may be placed upon the proprietor's representations as expressed in records, statements, and excise tax returns. The appropriate degree of testing will be that which may reasonably be relied upon to bring to light errors in about the same proportion as would exist in the whole of the population (universe, field, or area) being tested. In conducting any test, the ATF officer runs the risk of committing 2 types of errors:

(a) The statistical evidence might fail to support a tax value that is correct.

(b) The statistical evidence might support the tax value when the value is materially incorrect.

The ultimate risk is that a material error in the tax returns will occur in the accounting process and the ATF officer's examination will not detect it. The effectiveness of internal controls governs the

chance of a material error occurring. Therefore, the ATF officer should determine the effectiveness of internal controls for each population sampled.

c. Supervisory involvement is a critical element in the determination of whether to use statistical examination methods. Complex sampling plans for statistical sampling should be approved by the officer's supervisor prior to the initiation of the procedures. Also, the statistical sampling applications should be carefully monitored by the supervisor in order to reduce errors and the possibility of oversampling.

32. SAMPLING METHODS.

a. There are two major types of sampling techniques: statistical sampling and judgment sampling. Probability or random sampling are terms frequently used to refer to statistical sampling. The following is a summary of the characteristics of each type.

Judgment	Statistical
Subjective - Judgment affects the selection of the sample.	Objective - Random process of selection.
Results of examination are applicable only to those items examined.	Results from a sample drawn in this manner are representative of the entire population.
Results are not projectable.	Results are projectable to the entire population.
No way of measuring sampling error.	Objective estimation of sampling error.
Projection of results is not defensible.	Projection of results to the entire population is defensible.
Sample size cannot be determined.	Sample size can be estimated for given level of precision (acceptable risk).

b. As mentioned previously, judgment sampling is one of the two major types of sampling techniques. Although it has some limitations, it can be utilized to good advantage in tax compliance examinations.

(1) The term judgment sampling has been used to describe all non-probability sampling techniques. A judgment sample is selected purely on the basis of the opinion of the selecting individual as to the most typical or fruitful items to examine. Because of the subjective nature of this process, the value of this method is largely dependent upon the selector's knowledge of a specific plant's operations or problems.

(2) Generally, this method should be used to test small populations or to conduct testing at the smaller plants. Frequently, it may serve as an aid in determining whether to use statistical sampling procedures. For example, an officer might select this technique to check the effectiveness of internal controls and to test for recordkeeping violations at a plant where problems are not expected to occur. Judgment sampling could be used to verify inventory if a plant has good internal controls and a favorable compliance history. However, it might be necessary to convert to statistical methods if problems are discovered. Another application of this type would be to examine records prepared during periods of unusual activity, such as seasonal peaks, inventories, strikes, equipment changes, excessive losses or shortages, changes in accounting personnel or outside auditors, periods following major changes in laws or regulations, etc. Aside from knowledge of unusual events, periods of interest could be identified systematically through analysis of monthly reports.

(3) It is important to always remember the paramount limitations of this method, i.e., no defensible projection of the results of a judgment sample to all transactions is possible. However, in some cases it may not be important to project the results to all transactions but merely to indicate compliance with internal control procedures.

c. Statistical sampling is the other major type of sampling technique. It has been defined as a scientific method to review a sample of the entire population and project the sample results with a known precision. The sample must be randomly selected. Statistical sampling allows the direct determination of the reasonableness or amount of stated values or the determination of unknown values.

(1) The advantages of this method are summarized below:

(a) The amount of testing does not increase in proportion to the increase in the size of the area tested.

(b) The sample selection is objective.

(c) The method provides a means of estimating the minimum sample size associated with a specified risk.

(d) It is possible to estimate the sampling error, i.e., the probable difference in result due to the use of a sample in lieu of the entire area.

(e) It may provide a more accurate description of a large mass of data than examination of all the data, since nonsampling errors, such as clerical mistakes, are reduced.

(f) It may provide better coverage with less effort.

(g) With proper documentation of the sampling plan, it can be executed by different individuals with a high degree of consistency.

(h) Objective statistical evaluation of the results is possible.

(2) Statistical procedures may be used to test large populations, to project tax assessments, and to verify inventories, shortages and losses, and tax payments at the large plants or ones with a poor compliance history and/or weak internal controls. Of course, the facts and circumstances surrounding each examination must be evaluated to determine whether the time required to complete a statistical sample is sufficiently warranted.

33. TYPES OF STATISTICAL SAMPLING RECOMMENDED FOR USE BY ATF OFFICERS. Estimation sampling is a major classification of statistical sampling methods which includes attribute sampling and variable sampling. These methods provide answers to the questions "How many?" (attribute) and "How much?" (variable). For example, to determine how many shipping invoices were not properly posted to summary records is an application of attribute sampling. To determine how much wine was produced based on selected batch records is an application of variable sampling.

a. Attribute Sampling. If the sample is used as a means of establishing the frequency of occurrence of some kind

of event or type of item, the process is referred to as attribute sampling. The results of such a sampling operation are commonly expressed as a percent for the type of event specified. It is used to obtain an estimate of the error rate in the population.

(1) This method should be employed in compliance testing when verifying material attributes (e.g., proper posting of invoices to the sales journal, existence of certain inventories listed on perpetual records, or existence of support for adjustments to tax returns). Also, this procedure may be used to support conclusions concerning the correctness of extensions and footings, summary records, and other computations and postings.

(2) See paragraph 35 on sampling plans for guidelines on preparing a plan for attribute sampling.

b. Variable Sampling. Variable sampling is designed to provide an estimate of an average or total value, plus or minus the precision interval. Each observation provides a value (dollar amount) which is totaled for the sample. The average per sample unit is determined and then multiplied by the total number of units in the population to arrive at the point estimate.

(1) This technique will be utilized when numbered universes are to be verified. Numbered universes may be in dollars (e.g., gross sales), quantities (e.g., proof gallons, barrels, numbers of cigars), or any other group of numbers requiring verification.

(2) See paragraph 35 on sampling plans for guidelines on preparing a plan for variable sampling. A practical example is included in that section.

(3) Judicial precedents have been established as to the admissibility of legal evidence obtained through statistical sampling. This is true in both the private and public sectors. The use of statistical sampling methods as a basis for assessing taxes is an acceptable practice within the Internal Revenue Service. This principle is also applicable to tax assessments initiated by ATF. IT IS IMPORTANT TO REMEMBER THAT EXTREME CARE SHOULD BE EXERCISED IN THE USE OF STATISTICAL SAMPLING FOR TAX ASSESSMENT PURPOSES. Mistakes in the sampling process would seriously jeopardize ATF's position. In those situations where statistical sampling (variable sampling) will be the basis for a tax adjustment,

the ATF officer will design a sampling plan (or will amend the original sampling plan) to provide a confidence level of no less than 95 percent and a degree of precision no greater than plus or minus 5 percent. Expected error rate is not used in designing a variable sampling plan. The lower limit of the projection should be used as the tax adjustment. For example, after using valid procedures, the ATF officer estimates that the nontaxpaid removals at a proprietor were $10,000 plus or minus $500 at a confidence level of 95 percent. In this situation, the ATF officer should recommend a tax adjustment of $9,500.

34. OTHER TYPES OF STATISTICAL SAMPLING. The following methods are more complex than the ones previously discussed. All ATF officers should exercise caution when using these techniques to avoid time-consuming errors and/or distorted results.

a. Stratified Random Sampling.

(1) This is a method where the sample units or values are drawn from separate sections of the field independently, perhaps not in proportion to the number of items in the section of the population. However, within that segment (or stratum) of the field, the probability that any one sampling unit is included in the sample will be the same as for any other in that stratum.

(2) This technique is useful when it is found desirable to sample certain types of documents or entries separately. For example, this method could be used when all large value items are to be examined or a larger proportion of these items are covered than for smaller value items.

(3) It is characteristic of the stratified random sample that for each separate section or portion of the field tested, the sample is drawn by unrestricted random methods. However, this technique is more efficient than unrestricted random sampling where circumstances dictate special attention to certain groups of transactions (strata).

(4) There are several possible reasons for resorting to stratified sampling techniques:

(a) To gain sampling efficiency or, in other words, to obtain a lower sampling error with the same sample size as compared with unrestricted random sampling.

(b) To offset the effect of extreme values (skewed distributions).

(c) To give special attention to certain categories within the field.

(d) As a device for dividing the overall audit task among several officers or groups of officers and nevertheless providing overall estimates.

b. Cluster Sampling.

(1) This is a method where groups of items are drawn at random points. For instance, in sampling a file, it is possible to draw several records at a selected point. For example, the officer may wish to sample clusters of proof and fill test records from several days rather than sampling either individual record entries or entire days. This method saves time in drawing the sample since fewer points in the file are sought. However, this savings in time is frequently a delusion since a loss in sampling efficiency may result in requiring a larger overall sample size.

(2) A cluster sample may be obtained by using either the random number or systematic sampling technique (discussed later). Uniform cluster sizes should be used because these are the least complex to work with.

(a) When random number sampling is used, the document or entry specified by each drawn random number is located and that sampling unit plus a sufficient number of the following sampling units to comprise a cluster of the desired size are selected.

(b) When systematic sampling is used, a similar technique may be applied, with a sufficient number of items drawn after that specified by the sampling interval to comprise a cluster of the desired size. It is recommended that a cluster sample include at least 20 clusters.

(3) Cluster sampling may be used:

(a) If actual location and selection of the individual sampling units called for by the random numbers chosen is time consuming and expensive.

(b) If the time involved in locating and selecting the individual sampling units is as great as, or greater than, the time involved in the examination of the sampling units when located.

(c) If the items are widely scattered throughout a very large series of files, or dispersed at various locations, making the location of an individual document difficult to find. A glance at the document when already located is sufficient to determine the category into which it is to be classified. Perhaps only the amount needs to be recorded.

(d) If the selection of the documents requires the prior preparation of a long list of random numbers with considerable clerical work involved in the elimination of duplicates, arrangement in order, etc.

c. Multi-Stage Sampling.

(1) This is a technique involving sampling on several levels. For instance, in determining some characteristics of data at numerous offices or locations of the same organization, it may be possible to take a random sample of such locations and then to take a random sample of the records at each of these points. This method might be used to obtain an estimate of the total value of inventory of a certain type at different locations.

(2) Limitations:

(a) There must be a considerable number of locations.

(b) If there is a location which is unique with respect to the characteristic examined and which is, therefore, not comparable to other locations, there is some danger that a random sample of locations might omit such a unique point.

d. Systematic Sampling.

(1) This method of sampling involves drawing every "nth" item beginning with a random start. The sampling interval "n" is obtained by dividing the field size by the sample size.

(2) Systematic sampling should only be used with caution, because it is possible, when this method is used, that the sample result may be biased. Further, it may not be apparent from the sample that such a bias exists. Generally, a bias can result if there is any periodic or cyclical arrangement of the items in the file which is related to the characteristic being measured or tested. For example, if selecting every fifth working day to test an operation would lead to the same day of the week being selected over and over, any particular activities that the proprietor regularly scheduled on other days would be missed. This could also be true in using every "nth" file item. For example, if a random start of 3 was selected with a interval "n" of 100 and the company processed 100 items a day alphabetically arranged by customer name, the selected items 103, 203, 303 etc., would always involve the same customer.

35. PREPARATION OF SAMPLING PLANS AND RELATED WORKPAPERS.

a. The most critical phase in the application of statistical sampling techniques is the planning stage during which the sampling plan is developed. The approach to a test through sampling is a function of the objective of the test itself. Therefore, it is very important to clearly define the objective of each portion of the plan. The following are general guidelines for developing plans for attribute and variable sampling and examples of each:

(1) Sampling Plan for Attribute Sampling (ATF Form 5030.10 (Exhibit 7) includes these elements and may be used):

(a) State the Objective of the Test. An example would be estimating the error rate in posting daily removals of distilled spirits to the Sales Journal in order to assure the applicable excise taxes are timely paid.

(b) Define the Population. For this case, the population might be all postings to the Sales Journal for the examination period.

(c) Define the Sampling Unit. For example, individual sales invoices.

(d) Define the Attributes of Interest. It is common practice to perform multiple tests utilizing

the same random sample. In our example, attributes of interest could include correct invoice extensions, footings, and postings.

(e) Specify the Confidence Level. Generally, the confidence level will not be less than 95%. However, there may be occasions where less than 95% may be desired. This should be a matter of judgment between the field officer and supervisor.

(f) Estimate the Population Error Rate. This expected rate of occurrence in the population, based on experience with the proprietor, should not be higher than 5%. If a higher rate of occurrence is expected, methods other than attribute sampling should be employed.

(g) Specify Desired Sample Reliability. This is a measure of the ability to estimate the true error rate in the population. Generally, sample reliability should not exceed ± 3%. Again, there may be occasions where more than ± 3% may be desired depending upon the specific assignment. This should be decided between the field officer and supervisor.

(h) Determine the Sample Size. Sample size is determined from Table 2, Sampling in Auditing. Interpolation will not be applied. Instead, the larger sample size will be utilized.

(i) Select the Sample. A random sample must be selected.

(j) Perform the Tests. In this example, extensions, footing, and postings would be verified.

(k) Generalize from the Sample to the Population. Population error rate must be estimated as follows:

1 Determine the error rate in the sample as a percentage. Always round up to the next whole percent. In cases where the error rate in the sample exceeds the expected error rate, the sample reliability range will exceed the desired reliability range. If achieving the desired reliability is vital, then the sample size must

be expanded. However, conclusions may still be made from table 6a of Sampling in Auditing, recognizing that reliability will not be as tight as desired. There would be many cases where too small a sample will still tell the field officer what he or she wants to know, i.e., the estimate of how many errors are in the population within statistically valid parameters. The field officer under the circumstances of the assignment should use judgment to weigh the time needed to expand the sample against the gain in reliability.

2 Refer to Table 6 in Sampling in Auditing. In the case of a 0% sample error rate, Tables 6b and 6c should be used. Interpolation may be performed. Table 6 provides the estimated minimum and maximum estimated population error rates.

(2) Sampling Plan for Variables Sampling:

(a) State the Objective of the Test. For example, the objective might be to determine whether tax liabilities, as computed from data on invoices, are fairly presented in the general ledger Excise Tax Expense account. A dollar amount of the tax liability of all invoices for a period (the point estimate) would be calculated plus or minus the precision interval, and compared with the general ledger (Excise Tax Expense).

(b) Define the Population. Continuing the example, the population could be all sales invoices issued during the examination period.

(c) Define the Sampling Unit. The sampling unit, in this case, would be total tax liabilities as computed from individual invoices.

(d) Specify Desired Precision Limit per Sampling Unit. Precision is a matter of professional judgment, but will not exceed +5% without approval of your supervisor. Should the population consist of 1,000 invoices, and the g/l Excise Tax Expense account total $1,000,000.00, item precision (+5%) would be $50.00 per invoice ($1,000,000/1,000 X .05).

(e) Establish Confidence Level. The confidence level will not be less than 95% unless approved by your supervisor.

(f) Estimate Standard Deviation of the Population. Statistical calculations are based on the anticipated distribution of item values (e.g. barrels, cigarettes, invoice dollars) around the population average. The estimate is calculated as follows:

1 Take a preliminary random sample of 48, 49, or 50 items. This may be done utilizing random number tables or systematic (interval) sampling with a random start.

2 Arrange the items in groups of 5, 6, 7, or 8 in order of selection.

3 Determine ranges of the groups. Ranges, in the example, would be the difference between the lowest and highest dollar value of invoices in each group.

4 Average the ranges.

5 Obtain the d_2 factor for the group size used from Table 3, Sampling in Auditing, and divide into the average range, resulting in the estimated standard deviation.

(g) Calculate the Ratio of Sampling Error to Standard Deviation. Divide the estimated standard deviation into the desired item precision established in step (d). Should a ratio of less than .05 be obtained, your supervisor should be contacted for guidance.

(h) Determine the Sample Size. Utilizing the ratio from Step (g), confidence level and field size (population), sample size is determined from Table 4, Sampling in Auditing. Interpolation may be employed with this table as follows:

1 Do not interpolate for field sizes. Always use the larger number.

2 Interpolate using the ratio as necessary. For ratios between .05 and .09, round to the next highest hundredth (.061 would round to .07, as would .066). For ratios above .09, round to the next highest tenth.

(i) Select the Sample. Random selection must be employed. The initial samples may be included as long as the same random method used in (f)1 is employed.

(j) Average the Sample Values. In this case, invoice tax liabilities would be totaled and divided by sample size to determine the average value per sample unit.

(k) Project the Population Size. Multiply the average per sample unit times the number of units in the population, which results in the point estimate. The precision limits would be calculated as item precision ($50.00 from Step (d)) times the population of units (1,000 in this case).

(l) Determine Acceptability of the Population. In this case, if the general ledger total agrees with the point estimate ± $50,000.00 (1,000 X $50.00), the population is acceptable. Should the population value not fall within this range, contact your supervisor for guidance.

(3) Practical Application of Sampling Plan for Variable Sampling - Brewery:

(a) Objective - To determine the accuracy of reported removals (barrels) as represented on ATF F 5130.9, Brewer's Monthly Report of Operations.

(b) Population - Total number of shipments during the audit period: 24,432 (W/P _____).

(c) Sample Unit - Barrelage shipment line items reflected on EDP printout of Shipments Message Detail. Daily entries: Sum for audit period = 24,432.

(d) Precision - Point estimate of the population, ± 10% of the tax liability on an average shipment (Approved by supervisor: W/P _____). Justification:

1 Compliance History - No material adverse disclosures during previous 5 years.

2 Reported Taxable Shipping Errors - Adjustments resulting in increased tax liability are made frequently - Good faith is exhibited.

3 Billing Practices - Home office billing precludes local motive for collusion in shipment misstatements.

4 Internal Control - Favorable in shipping and security. Validation testing of production, bottling and finished goods to date disclosed no errors in Government reports.

Calculation:

Reported Removals (Bbls.) (W/P _____)	4,689,616,840
Divided by No. of Shipments	24,432
Average Bbls. Per Shipment	191.94568
Precision	X .10
Item Precision (Bbls.)	±19.19456

(e) Confidence level - 95 Percent

(f) Standard Deviation

1 Initial Sample - Random Interval Basis.

Population 24,432 / 48 = 509

Starting point was blind stab in random number tables, reading left to right. Selected first number within range of 0-509, or 348. Selected 348th shipment (cases) and each subsequent 509th shipment, for a total of 48.

2 Range Determinations (W/P _____).

Established eight sample groups of six in their order of selection, and converted cases to barrels. Determined as the range of each group the differences between the highest and lowest quantities.

3 Average Range

$$\frac{\text{Sum of all ranges}}{\text{Number of ranges}} = \text{Average range}$$

$$\frac{3118.968}{8} = 389.871$$

4 Estimated Standard Deviation (ESD)

Average range / d_2 factor (Group size 6): $\frac{389.871}{2.534} = 153.856$

(g) Ratio of Sampling Error to Standard Deviation

Precision (From Step (d)) ± 19.19456
Divided by ESD (from Step (f)4) 153.856 = .12475

(h) Sample Size (Pop. 24,432)

Interpolation:

Sample size w/ratio .10	383
Sample size w/ratio .15	-170
Difference	213
Divided by units of difference between .10 & .15	5
Sample items per unit of difference	42.6
Times units of difference between .10 & .12475	x2.475
No. sample items represented by difference	106
Plus sample size w/ratio .15	+170
Sample size	276

(i) Sample Selection

48 - From Item (f) (Interval basis)
228 - From continued intervals of 509 (W/P ____).
276 (Other random method may be used).

(j) Average Sample Unit (Dollars or Quantities)

Barrels removed per sample (W/P _____) $\frac{56,253.216}{276} = 203.816$

(k) Population Projection

Point estimate:

Average sample unit	203.816
Sampling unit population	x 24,432.000
Point estimate of population (Bbls.)	4,979,632.512

Precision interval:

Item precision	19.195
Sampling unit population	x 24,432.000
Precision interval (Bbls.)	468,972.240

Variable estimates:

Point estimate	4,979,632.512
Precision interval	+ 468,972.240
Upper precision limit	5,448,604.752
Point estimate	4,979,632.512
Precision interval	- 468,972.240
Lower precision limit	4,510,660.272

(l) Population Acceptability

Reported removals	4,689,616.840
Upper precision limit	5,448,604.752
Lower precision limit	4,510,660.272

Reported removals (Variable to be estimated) fall within precision limits.

b. Workpaper Preparation.

(1) The basic concepts of good workpaper preparation apply to statistical sampling. In fact, due to the complexities involved, extreme care is required to assure that workpapers adequately document the scope of work. Legends or narrative descriptions should be included to identify the sampling frame, sampling unit, and other information. When drawing any conclusion based on statistical sampling, a statement should be made in the workpaper of the confidence level and the degree of precision applicable to that conclusion.

(2) The entire sampling plan should be included in the workpapers.

(3) The use of statistical sampling methods should be discussed in advance with the controller, statisticians, internal auditors, or other appropriate personnel of the proprietor whenever possible. The purpose of such discussions is to establish, in advance, mutual acceptance of the sampling procedures. These discussions should be documented in the workpapers. The lack of mutual acceptance does not preclude the use of statistical sampling.

CHAPTER J. EXAMINATION OF ELECTRONIC DATA PROCESSING (EDP) SYSTEMS

36. SCOPE. This section is intended as a brief guide to ATF officers in conducting examinations of businesses which use electronic data processing in their recordkeeping system. Since this subject cannot be fully covered in the limited space available in this handbook, a list of sources for further information has been provided as Appendix I. A glossary of EDP terms is included at Appendix II.

37. PRELIMINARY STUDY OF INTERNAL CONTROL.

a. Evaluation of the EDP System. The preliminary review phase consists of inquiries directed to EDP managers. Predetermined questionnaires may be helpful. This review should give the officer an understanding of (1) how the computer is utilized in the particular business; (2) the significant applications, relative to examination objectives, of the computer; (3) the extent to which EDP is used in each significant application; and, (4) the basic structure and interrelationships of manual and EDP controls. (see Revenue Procedure 64-35 for approval and access to ADP documentation, CCH paragraph 40,263).

b. Assessment of Preliminary Review Findings. After completing the preliminary review, the officer should be able to assess the significance of internal control within EDP, in relation to examination objectives, and determine the extent of review (if any) of internal controls needed.

(1) The officer may conclude that internal control procedures within EDP appear to provide a basis for reliance thereon and for restricting the extent of substantive testing. In that event, the officer would complete the review of EDP internal control procedures, perform tests of compliance, and evaluate the control procedures to determine the extent of his reliance thereon and the extent to which substantive tests may be restricted.

(2) The officer may conclude that there are weaknesses in the EDP internal control procedures sufficient to preclude any reliance on the procedures. In this case, the officer would discontinue the review of EDP internal control and forgo performing any compliance tests. The officer would assess the potential impact on the tax liability and associated returns and reports and would accomplish the examination objectives by other means.

(3) The officer may decide not to extend the preliminary review and not to perform tests of compliance related to internal control procedures within the EDP application even though the controls appear adequate. No reliance would be placed on the EDP internal control. Situations of this type include those in which:

(a) The effort required to complete the review and test compliance would exceed the reduction in effort that could be achieved by reliance upon the EDP internal controls, i.e., increased substantive testing of EDP output would be more cost-effective.

(b) Certain EDP internal control procedures are redundant because other adequate internal control procedures are in place.

38. EVALUATION OF INTERNAL CONTROLS (EDP).

a. EDP Controls. The evaluation of internal controls in an electronic data processing application is not different conceptually from the evaluation of internal controls in other areas. EDP controls are classified in two categories:

(1) General controls relate to all EDP activities, and include the plan of organization, procedures for documenting, reviewing, testing and approving programs, hardware controls built in by equipment manufacturers and controls over access to equipment, files and programs.

(2) Application controls relate to specific tasks performed by an EDP system and consist of input controls, processing controls and output controls.

b. Function of Controls. Taken together, general and application controls should operate to provide reasonable assurance of prevention and detection of the following type of errors that might occur:

(1) Errors in converting transaction data to machine-readable form.
(2) Errors in correcting and resubmitting data initially rejected by the system.
(3) Destruction or damage of machine readable files. (The ATF officer should verify that the company has a valid back-up procedure such as duplicate computer tapes to prevent a total loss of stored information.)

(4) Processing invalid transactions.
(5) Failing to process valid transactions.
(6) Processing unauthorized transactions.
(7) Improper valuation of transaction data.
(8) Erroneous classification of transaction data.
(9) Failing to post control and subsidiary accounts properly.
(10) Erroneous dating and recording of transactions.
(11) Manual overrides of the EDP system.

c. Compliance Testing. The purpose of compliance testing is to provide reasonable assurance that internal control procedures are being applied as prescribed. This is only necessary if the officer plans to rely on the EDP internal controls. The tests should be designed to determine: 1) if the procedures were performed, 2) how they were performed, and 3) by whom they were performed. How testing is accomplished will depend on the nature of the procedure to be evaluated.

(1) Some procedures leave visible evidence indicating that the procedures were performed. An example is a file documenting program changes, and approval of the changes. Other examples are error listings, exception reports and console logs.

(2) Some procedures leave no visible evidence indicating that the procedures were performed. These controls may be tested by reviewing transactions submitted for processing to determine that all unacceptable conditions have been disclosed and resolved. This can be done manually or through the use of independent programs. An alternative is to review and test the programs and then to perform tests to assure that the tested programs actually were used. This approach should be taken only when there are effective controls over access and changes to programs used for processing.

(3) Some control procedures leave neither visible or machine readable evidence. An example is segregation of functions, which could be tested by observing the proprietor's personnel and making inquiries.

d. Evaluation of Results of Study and Testing of Internal Control. After completing the study and compliance testing of EDP internal control procedures, the officer can evaluate the results in the same manner as other internal controls and adjust substantive testing accordingly. (See the diagram referred to in CHAPTER F - EVALUATION OF PROPRIETOR'S CONTROLS.)

39. EDP TESTING TECHNIQUES.

a. Auditing Around the Computer. In auditing around the computer, the officer ignores computer programs. The EDP output is tested manually to determine the accuracy of the data. To accomplish this the officer selects a sample of input transactions, manually performs the processing done by the EDP equipment, and compares the results with the actual results obtained by the computer. For example, the officer may select all shipping invoices for a particular period, convert quantities to a standard (barrels, proof gallons), and compare the total to the results shown in the computer print-out for the same period. This technique requires little technical training in computers, is simple and straightforward, and entails no risk of tampering with live data. It may be the only method available to officers in examinations at remote plant sites or in other cases where access to the computer is not practical or possible. Auditing around the computer would be appropriate when the officer has ready access to source documents to compare with the EDP output. This method is often more cost-effective than other techniques when the volume of transactions to be tested is relatively small.

b. Auditing Through the Computer. There are three primary approaches used to audit through a computer. Technical training beyond the scope of this handbook is necessary to effectively use these methods.

(1) Test Deck. The test deck requires the preparation of a series of test transactions. These transactions should represent all conceivable variations of possible transactions and input errors. The test deck is run on the computer system using the proprietor's normal program. This approach will give an objective assessment of a computer program, but it requires careful, time-consuming planning and requires some expertise on the part of the officer, and does not give meaningful results unless you can establish that the program being tested is the one the proprietor always uses.

(2) Controlled Reprocessing. In this approach the officer uses a controlled program, written or obtained by the officer, that is known to be adequate to process the proprietor's data. An output report produced by running the controlled program is then compared with output of the regular processing.

(3) Integrated Test Facility. This is the establishment of a "dummy" entity through which data can be

processed (e.g., a fictitious customer). Test transactions are processed using proprietor's regular program.

c. Auditing with the Computer. There are two general approaches being used to audit with the computer. Technical training or experience beyond the scope of this handbook is necessary to effectively use these methods and, therefore, only highly trained officers use this approach.

(1) Specialized Audit Programs. In this approach, a special program is written for use on the proprietor's equipment to perform a particular function. For example, all shipments for the period could be totaled and converted to taxable quantities for comparison to total excise taxes paid. These programs may be written by ATF personnel or by the proprietor's programmers with subsequent testing by ATF personnel for validity.

(2) Generalized Computer Audit Software. In this approach, computer programs are obtained from independent sources which are compatible with many EDP systems and can be used to test the reliability of the proprietor's programs as well as to perform specific audit functions. These programs can perform functions essentially equivalent to those of the proprietor's programs. In this process, termed parallel simulation, the program compares the simulated output with the proprietor's actual output, generating a listing of discrepancies. These discrepancies are then reconciled by the ATF personnel.

Spirituous Liquors
Erehwon, NH
DSP-NH-XX

REVIEWED BY: [signature] 5/5/83

DISTILLED SPIRITS PLANT
EXAMINATION PLAN
(Revenue Protection)

Period of Inspection 5/1-80 to 4/30-83

	INITIALS	DATE	W/P REF.
I. QUALIFYING DOCUMENTS Objective: To determine that all qualifying documents are currently filed and accurate.			
A. Verify the accuracy of the most currently approved Notice of Registration and Plat.	SLH	5/4/83	I/1
B. Check FAA Basic Permit for accuracy.	SLH	8/15/83	I/1
C. Verify the amount and adequacy of the Bond and Consents of Surety.	SLH	8/15/83	I/2
D. Verify signature authority for those persons signing documents submitted to ATF.	SLH	8/15/83	N/A
E. Review Special Authorizations on file with ATF.			
1. Verify that they are still in use. 2. Update plant file, if necessary.	SLH	7/15/83	I/3
F. Examine organizational documents for changes in ownership, officers or directors.	SLH	5/4/83	N/A ①
II. PREMISES AND EQUIPMENT Objective: Verify security of the premises and that equipment meets regulatory requirements.			
A. Examine buildings and equipment and note any discrepancies.	SLH	5/4/83	N/D, N/A
B. Check for proper tank markings.	SLH	5/4/83	N/D, N/A
C. Verify that all tanks have measuring devices which meet the requirements of regulations.	SLH	8/15/83	N/D; N/A

Spirituous Liquors
Erehwon, NH
DSP-NH-XX

	INITIALS	DATE	W/P REF.
III. PHYSICAL INVENTORY Objective: To determine the quantity of distilled spirits on hand, in cases and in bulk, and reconcile to the book inventory as reported on Form 5110.28 (Monthly Report).			
A. Case goods: Inventory was verified 12/30/82 and was the subject of a separate inspection. I will not conduct another inventory.			N/A
B. Bulk			
1. Determine the proprietor's inventory procedures and evaluate those procedures.	SLH	9/7/83	IV/22
2. Observe an inventory conducted by the proprietor to verify that the procedures are followed.	SLH	"	"
3. Do a test count and verify to the proprietor's count and to the inventory record.	SLH	"	"
4. Participate in any recounts.	SLH	"	"
5. Verify proprietor's calculations and footings.	SLH	"	"
6. Investigate any unusual losses or gains.	SLH	"	"
IV. RECEIPTS OF BULK DISTILLED SPIRITS Objective: To determine if bulk spirits received in bond are accurately accounted for and posted into the processing records.			
A. Summarize all bulk operations using the Monthly report, Form 5110.28 and evaluate the activities. (This will include activities covered by Part V)	SLH		IV/14B IV/12-21
B. Observe the receipt of bulk shipments of distilled spirits.	SLH	7/15/83	N/A, N/A

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Erehwon, NH
DSP-NH-XX

	INITIALS	DATE	W/P REF.
C. Sample bulk receipts on Form 5110.27 and verify to invoices or other commercial documents.	SKH	8/15/83	II/1-11
V. PROCESSING AND BOTTLING Objective: To determine that all spirits are accounted for during the processing and bottling operations.			
A. Verify completions reported in the summary records to bottling line records, using a sampling method.	SKH	5/28/83	V/1-8
B. Foot completion summary records and verify to the Monthly Report, Form 5110.28 for one month of each quarter covered by this examination.	SKH	5/28/83	V/1-8
C. Evaluate losses identified by the summary done at Part IV, A. If possible, verify to internal management information, such as cost accounting information.	SKH	8/15/83	N/A
D. Verify that remnants are accurately accounted for and that remnant bottles are made secure.	SKH	8/15/83	N/A, N/A
VI. BOTTLED GOODS (AFTER COMPLETION) ON BONDED PREMISES Objective: To determine if bottled spirits are properly accounted for and taxpaid.			
A. Summarize bottled spirits activity from Form 5110.28 and evaluate the information. (This includes bottled goods being returned to bonded premises).	SKH	8/15/83	VI/5 & VI/6
B. Summarize all taxpayments for the examination period, including adjustments, from Form 5110.35 (Tax Return).	SKH	8/16/83	VI/1, VI/4 VI/7 SERIES VI/8-VI/11

Spirituous Liquors
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	INITIALS	DATE	W/P REF.
C. Taxable Removals			
1. Sample invoices covering removals and verify that they are accurately recorded in the daily summary records.			
a. Determine that all removals are paid in the proper tax return period.	SKH	8/15/83	VI/14
b. Verify that all shipping adjustments are accounted for.			
2. Sample daily summary records for mathematical accuracy and inclusion on the tax return, Form 5110.35	SKH	8/15/83	VI/14
3. Cross-check tax returns and monthly reports.	SKH	8/15/83	VI/14
D. Exports			
1. Sample Forms 206 and compare to invoices.	SKH	7/7/83	VI/12 & VI/12-1
2. Verify that the sampled exports are entered into the daily record.	SKH	7/7/83	VI/12 & VI/12-1
E. Breakage			
1. Review the bottled spirits summary (VI A) for any significant variations in breakage reported.	SKH	7/15/83	N/A
2. Review and sample breakage reports for:	SKH	7/19/83	VI/16
a. Proper recording in summary records.	"	"	"
b. Unusual entries.	"	"	"

Spirituous Liquors
Erehwon, NH
DSP-NH-XX

	INITIALS	DATE	W/P REF.
F. Samples			
1. Spot-check sample records and compare them to the daily summary records.	SLH	7/19/83	N/D, N/A
2. Determine that samples are being removed and accounted for according to 27 CFR 19.721.	SLH	7/19/83	N/D, N/A
G. Review the tax removal summary (VI B) and trace any adjustments not previously investigated, with a taxable liability of over $150.00	SLH	8/15/83	VI/7-11 VI/17 ②
VII. CLOSING ACTIONS			
A. Discuss findings with Area Supervisor.	SLH	8/16/83	–
B. If necessary, prepare a Report of Violations.	SLH		NOT NECESSARY
C. Hold clsoing conference with Plant representatives.	SLH	9/8/83	–
D. Prepare a Report by exception.	SLH		

N/A - WORKPAPER NOT NECESSARY
N/D - NO DISCREPANCIES NOTED
① ALL CORPORATE INFORMATION AT HEADQUARTERS OFFICE
② COMPUTATION OF EXCESS TAX CLAIMED FOR BRANDY EXPORT DRAWBACK

Spirituous Liquors
DSP-NH-XX
5/1/80-4/30/83

Index

A-I Typed Copy of Examination Report
A-II Draft Report

B-I Examination Assignment Sheet
B-II Summary of Time and Travel

C-I Review Comments - Team Leader
C-II Review Comments - Other

D Conferences

E-I Planning Data
E-II Compliance History

F Work of Others

G Evaluation of Internal Controls

H Examination Plan

H-I Qualifying Documents

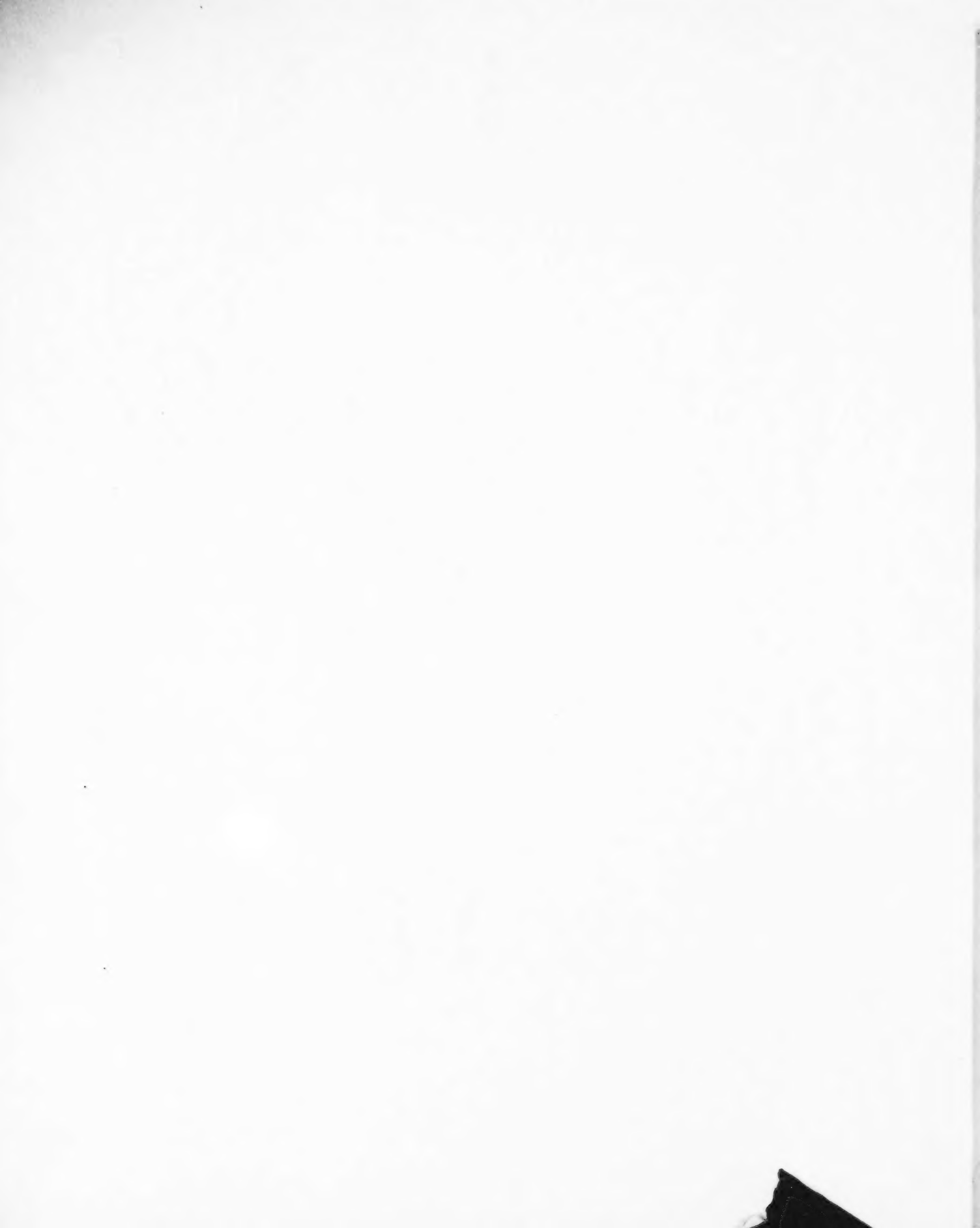
H-III Physical Inventory

H-IV Receipts of Bulk Distilled Spirits

H-V Processing and Bottling

H-VI Bottled Goods (After Completion) on Bonded Premises

	Init	Date
Prep by	____	____
Rev by	____	____



PREPARATION OF SUMMARIES

The nature and results of our work on each segment of an assignment should, as a matter of systematic operation and good workmanship, be summarized in a clear and concise manner in the workpapers. A segment may be considered as referring to an aspect or group of aspects of a finding or subject. The purpose of these summaries, as the name implies, is to sum up in a clear, concise, and convincing manner and to bring to the forefront the essence of the work performed, the results achieved, the conclusions reached, and any recommendations, as reflected in the supporting workpapers.

a. They force a timely and critical analysis of the evidence obtained and work performed, help identify additional requirements, and serve as a basis for decisions as to the disposition of the results of the work.

b. They make possible the drafting of the report as an integral part of the fieldwork.

c. Summaries also are beneficial in that:

   (1) They provide an orderly and logical flow to the papers and facilitate supervisory or other reviews of particular work segments when tying together groups of workpapers relating to a particular point.

   (2) They become the focal point in the workpapers for any particular work segment when appropriately indexed and cross-referenced. Additionally, they provide a mechanical control over the underlying workpapers. Depending upon their depth and coverage, they can also be useful in resolving any later questions which may present themselves after completion of the assignment.

d. The basic elements of a segment summary are as follows:

   (1) Objective or Purpose. This section should provide a clear statement of the purpose of the work, an explanation of why it was undertaken, and what is being accomplished.

   (2) Scope of Work Performed. This section should state concisely what was performed relative to what was set to be accomplished. If unable to examine certain records or do work that was intended, this should be explained in this section.

(3) Conclusions. Although frequently apparent from the evidence, conclusions should be stated in relation to the objectives. The rationale for the conclusions should be presented and be relative to the work performed or information developed.

(4) Recommendations. Any recommendations for corrective action should follow logically.

e. As a general rule, summaries are narrative presentations - although they may include tabulations or schedules and state the findings and conclusions justified by the evidence. Summaries will remain with the workpapers as evidence for later referral or follow-up and may be used as a basis for a position or statement in the examination report.

ABC Brewery, Humble, TX
10/1/83 - 9/30/84
Inventory Questionnaire
Source: Mr. D. E. EFF, Controller

Question	Answer Yes	No	NA	(Ref./Supt.Test)
1. Are perpetual inventories maintained including quantities and values?				
2. Are physical inventories periodically taken?				
3. Is access to the stockroom or warehouse controlled?				
4. Are goods kept neatly and in order?				
5. Is material released from warehouse or storeroom on the basis of approved and pre-numbered requisitions or shipping orders?				
6. Are storekeepers or warehouse personnel required to report on obsolete, unusable, slow moving, or over-stocked items?				
7. Is adequate control maintained over material in the hands of suppliers or processors?				
8. Is adequate control maintained over goods shipped in or shipped out?				
9. Are aged schedules of inventory prepared and reviewed by a responsible executive?				
10. Are all inventory classes physically counted during the year?				

	Init	Date
Prep By	____	____
Rev By	____	____

ABC Brewery, Humble, TX.
Inventory Questionnaire (continued)

Question	Answer Yes	No	NA	(Ref./Supt.Test)
11. Are inventories off premises confirmed or physically counted during the year?				
12. Are pre-numbered tags used in counting of physical inventories?				
13. In physical inventories:				
A. Are instructions on taking inventories written?				
B. Is there adequate supervision?				
C. Are items clearly marked for identification?				
D. Do the tags adequately describe the merchandise?				
E. Are items counted by one employee and rechecked by another employee?				
F. Are cut-off controls at the time of physical inventory reviewed?				
G. Are discrepancies between book and physical inventories investigated?				
H. Are perpetual records promptly adjusted for discrepancies resulting from physical count?				
I. Are adjustments to perpetual inventories approved by a responsible official?				

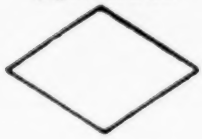
	Init	Date
Prep By	____	____
Rev By	____	____

STANDARD FLOWCHART SYMBOLS

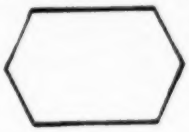
INPUT/
OUTPUT

DOCUMENT

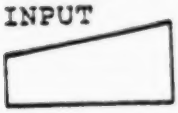
DECISION



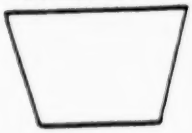
PREPARATION



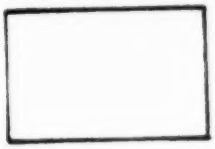
MANUAL
INPUT



MANUAL
OPERATION



PROCESSING



AUXILIARY
OPERATION

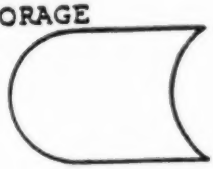
DISPLAY
OUTPUT

MAGNETIC
TAPE

TRANSMITTAL TAPE

PUNCHED
CARD

OFFLINE
STORAGE

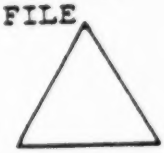


ONLINE
STORAGE

PRODUCT
FLOW

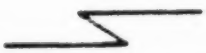
TEMPORARY
FILE

PERMANENT
FILE



RECORDS
FLOW

STARTING
POINT



COMMUNICATIONS
LINK

CONNECTOR

FLOWCHART FORMAT

1. The flowchart should contain at least the following: a) name of the company, b) procedure being documented and analyzed, c) name of preparer, d) date of preparation, and e) source of information.

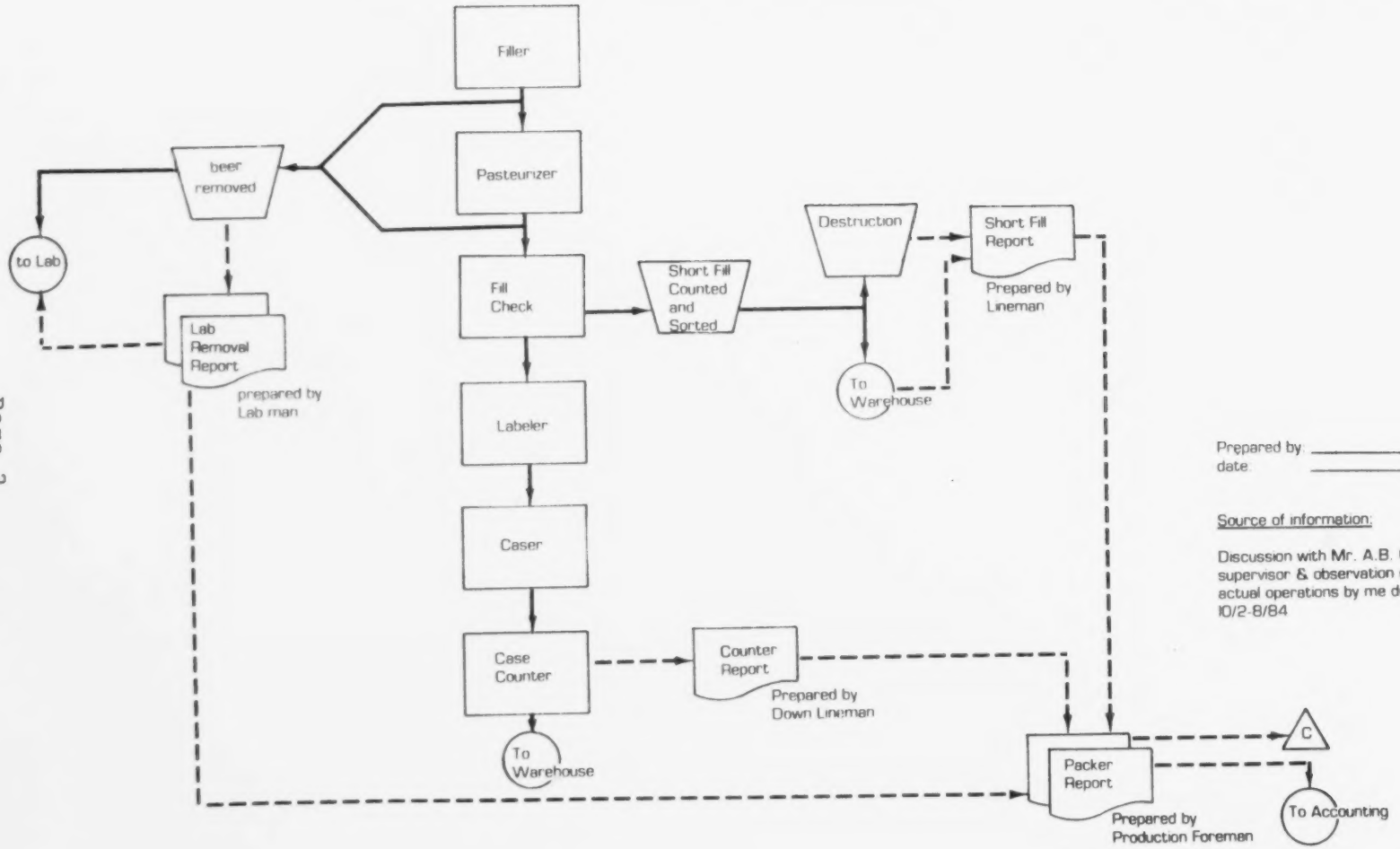
2. A template, a ruler, and standard symbols should be used. In addition, any symbol for files should indicate whether the files are kept alphabetically, numerically or chronologically.

3. The starting point should be at the upper left-hand corner if possible.

4. The flow of procedures and documents should be from left to right and from top to bottom as much as possible.

5. Narrative explanations should be written on the face of the chart as annotations or written in a readily available reference key.

ABC Brewery, Humble, TX
Packaged Beer Production



Prepared by: _____
date: _____

Source of information:

Discussion with Mr. A.B. Coe, Production supervisor & observation of actual operations by me during 10/2-8/84

DEPARTMENT OF THE TREASURY
BUREAU OF ALCOHOL, TOBACCO AND FIREARMS

ATTRIBUTE SAMPLING WORKSHEET

INDEX NUMBER

PROPRIETOR	PERMIT NO. *(If any)*	RELATED AUDIT PROGRAM

1. STATEMENT OF SAMPLING OBJECTIVE

2. DEFINITION OF "OCCURRENCE" OR "ERROR"

3. UNIVERSE IS COMPRISED OF

4. ELEMENTARY UNIT IN UNIVERSE

SAMPLE

5. SAMPLING UNIT	6. SIZE OF UNIVERSE

7. MAXIMUM TOLERABLE SAMPLING ERROR	8. CONFIDENCE LEVEL
± _____ %	_____ %

9. ESTIMATED RATE OF OCCURRENCE IN UNIVERSE	THIS RATE OF OCCURRENCE IS BASED ON
_____ %	☐ PILOT SAMPLE OF _____ *(Sampling Units)* ☐ INSPECTOR'S JUDGMENT

10. SAMPLE SIZE *(No. of Sampling Units)*

SAMPLE SIZE BASED ON 7, 8, AND 9 ABOVE AND:

☐ GRAPHS IN AUDIT HANDBOOK ☐ FORMULA _____

☐ TABLE 2 IN SAMPLING IN AUDITING ☐ OTHER *(Specify)*

11. RANDOM SELECTION METHOD UTILIZED	12. NO. OF ERRORS FOUND IN SAMPLE *(If none, skip to line 17a)*
☐ SYSTEMATIC RANDOM ☐ OTHER *(Specify)* ☐ UNRESTRICTED RANDOM NOS. *(Table and starting point)*	

13. PERCENT OF ERRORS IN SAMPLE *(Line 12 ÷ line 10 x 100)*	14. PROBABLE NUMBER OF ERRORS IN UNIVERSE *(Line 13 x line 6)*

15. PERCENT RANGE OF ERRORS IN UNIVERSE *(Table 6 or Table 6a, Sampling in Auditing)*	16. RANGE OF ERRORS IN UNIVERSE *(Line 6 x lines 15a & 15b)*
a. _____ % *(Maximum)* b. _____ % *(Minimum)*	a. _____ *(Maximum)* b. _____ *(Minimum)*

17. NO ERRORS FOUND IN SAMPLE

a. MAXIMUM PERCENT OF ERRORS POSSIBLE IN UNIVERSE *(Table 6b/c, Sampling in Auditing)*	b. MAXIMUM NUMBER OF ERRORS POSSIBLE IN UNIVERSE *(Line 17a x line 6)*

CONCLUSION STATEMENT

I am _____ % sure that the actual number of errors in the universe is somewhere between _____ *(Line 16b)* and _____ *(Line 16a)* errors.
(Confidence Level from Table 6)

or, in the case of no errors in sample, *(Zero)* *(Line 17b)*

SIGNATURE OF INSPECTOR	DATE

ATF F 5030.10 (6-79)

APPENDIX I

Additional References on Auditing EDP Systems

U.S. General Accounting Office, Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, (Washington, U.S. Govt. Print. Off., 1981)

U.S. General Accounting Office, Auditing Computer-Based Systems, (Washington, U.S. Govt. Print. Off., 1979)

Auditing Standards Executive Committee, The Effects of EDP on the Auditor's Study and Evaluations of Internal Control, SAS No. 3, (New York, American Institute of Certified Public Accountants, Inc., 1974)

Meigs, Larson and Meigs, Principles of Auditing, (Irwin, 1977)

Jack C. Robertson, Auditing, (Dallas, Business Publications, Inc., 1979)

Burch and Sardinas, Computer Control and Audit: A Total Systems Approach, (New York, John Wiley and Sons, Inc., 1978)

Mair, Wood and Davis, Touche Ross & Co., Computer Control and Audit, 2nd ed., (Altamonte Springs, FL, The Institute of Internal Auditors, 1976)

APPENDIX II

A Glossary of EDP Terms

Application controls Internal controls relating to a specific accounting task, such as preparation of a payroll.

Batch A group of transactions processed in sequence as one lot.

Boundary protection Protection against unauthorized entry (read or write) to a tape, disk, or other storage device.

Control total A total of one information field for all the records of a batch, such as the total sales dollars for a batch of sales invoices.

Disk A random access storage device consisting of a circular metal plate with magnetic material on both sides.

File An organized collection of related records, such as a customer file, which is usually arranged in sequence according to a key contained in each record.

File integrity The accuracy and reliability of data in a file.

General controls Internal accounting controls which relate to all EDP applications. The category includes organizational controls, documentation, equipment controls, and security controls.

Hard copy Computer output in printed form, such as printed listings, reports, and summaries.

Hash total A meaningless control total, such as the total of all invoice numbers in a batch of sales invoices, utilized to determine whether data are lost between operations.

Header label A machine readable record at the beginning of a file which identifies the file.

Integrated test facility A set of dummy records and files included in an EDP system enabling test data to be processed simultaneously with live input.

Interface To run two or more files or programs simultaneously in a manner permitting data to be transferred from one to another.

Master file A file of relatively permanent data or information which is generally updated periodically.

Off-line Pertaining to peripheral devices or equipment which are not in direct communication with the central processing unit of the computer.

On-line Pertaining to peripheral devices or equipment which are in direct communication with the central processing unit of the computer.

Patch A new section of coding added in a rough or expedient way to modify a program.

Program flowchart A graphic representation of the major steps and logic of a computer program.

Random access Pertaining to a storage technique in which the time required to gain access to data is not significantly affected by the location of the data in storage. A disk is a random access device.

Record A group of related items or fields of data handled as a unit.

Record layout A diagram showing all the fields of data in a record and their arrangement in the record.

Self-checking number A number which contains a redundant suffixed digit (check digit) permitting the number to be verified for accuracy after it has been transferred from one device or medium to another.

Sequential access Pertaining to a storage technique in which the time required to gain access to data is related to the location of the data in storage. Magnetic tape is a sequential storage device.

Terminal An on-line input device. Many terminals are portable and may be connected to the computer through ordinary telephone lines. The method of entering data is usually a typewriter keyboard or an optical scanner.

Test deck A set of dummy records and transactions developed to test the adequacy of a computer program or system.

Third party review (of a computer service center) An evaluation and report by an independent auditor on the internal accounting controls at a computer service center. Other auditors make use of this report in evaluating the internal control over data processing performed for their clients by the service center.

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